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Certified Public Accountant

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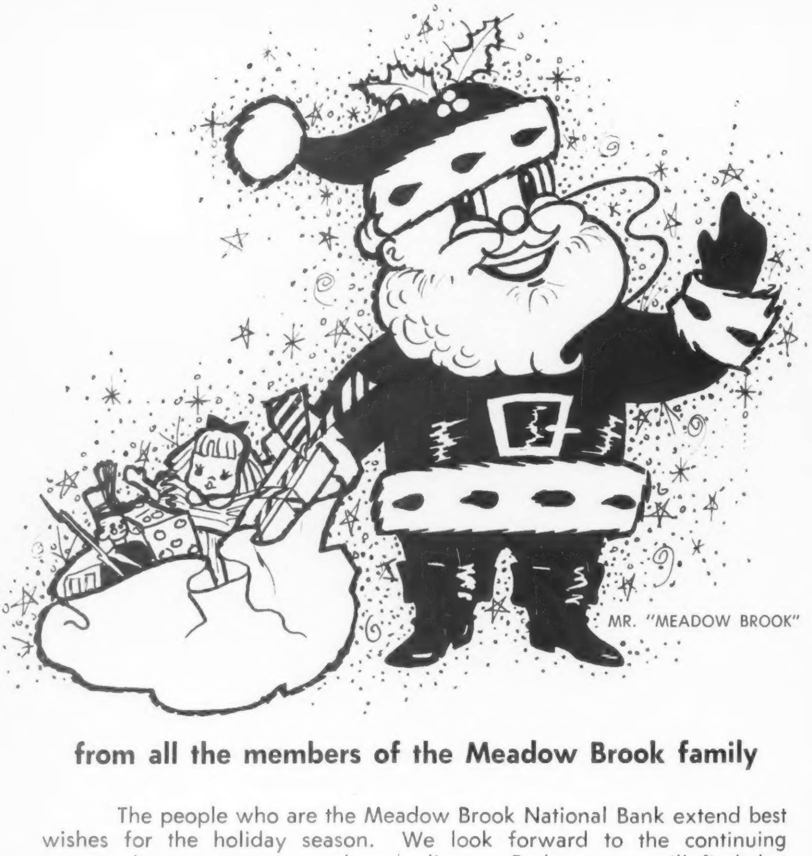
SEASON'S GREETINGS



from all the members of the Meadow Brook family

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Accounting News And Trends

PENALTY FOR VIOLATION OF CONFIDENCE

In the recent British case of *Fogg* v. *Gaulter and Blane* commented upon in the September, 1960 *Accountancy* (Great Britain) the defendants, a firm of chartered accountants, were ordered to pay one hundred pounds for breach of the duty of secrecy.

The facts in the case were that there had been a legal controversy between the plaintiff and relatives of her late father-in-law involving the question of whether her late husband and his father had been partners. In preparing that case solicitors for the relatives approached the accountants herein sued and asked to examine the tax returns of the father-in-law. Permission was granted and, in going through the files, tax returns for the son were discovered. When asked for copies of these returns, the accountants, without protest and without threat or pressure of any kind being put on them, supplied them to the solicitors. The son's widow then sued the accountants for damages because of their breach of duty.

The court held that the accountants owed the duty of secrecy and, although an appropriate court order might have compelled the production of the tax returns, "it was quite wrong and a breach of duty on the part of the accountants to produce the son's return to those acting against his widow in hostile litigation, without her consent as the son's personal representative and otherwise than under an order of the Court." They were accordingly liable in damages.

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Accounting Procedure and is Program Director of the Brooklyn Chapter of the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

LARGE SIZE SAVINGS BANK DEPOSITS NOW POSSIBLE

CPAs whose clients include union and welfare funds, estates, charitable foundations, and others with substantial sums to invest will be interested in the new service developed by New York State mutual savings banks for all types of depositors.

Since mutual savings banks by law cannot accept deposits of more than $10,000 on single accounts, depositors of large sums were heretofore obliged to deal with a number of individual banks. Under the new service, Savings Banks Trust Company, created over 25 years ago by the New York State savings banks, will accept a single check for as much as $1,250,000 and, acting as agent for the depositor, will distribute the total deposit among the participating savings banks in units not to exceed the legal limit of $10,000. There is no charge to the depositor for this service and each deposit is fully insured by the F. D. I. C.

The only forms necessary to sign are a short agreement designating the Trust Company as agent for the depositor and a short form of certificate describing the account and setting forth the authorized signatures for

withdrawal requests. Withdrawals may also be made in a single transaction on a blanket withdrawal application.

The necessary forms for opening any of these accounts are obtainable from Mr. John Mackey, coordinator of the plan, at the office of Savings Banks Trust Company, 14 Wall St., New York 5, N. Y.

ADVICE ON WORK PAPERS AND FINANCIAL STATEMENTS

Three comments made by Mr. E. R. Billings in his article "The Review of Audit Working Papers" (*The Michigan CPA* May, 1960) are particularly pertinent. They concern the actions of the staff accountant, the method of changing work papers, and the extent of the final review.

Before the accountant who prepares any working paper analysis can consider the job complete, he should give it a final overall scrutiny and ask himself these three questions:

1. Is the analysis complete in that it fully and accurately presents the information it is intended to present?
2. Are the verification procedures performed in connection therewith adequate, and are they clearly indicated?
3. Are all comments, explanations, or exceptions of any kind clearly and concisely set forth?

In discussing making changes in work papers the suggestion is made that erasures should be made only by the one who originally wrote the material. In other cases changes should be made by drawing a line through the material and inserting the change. The reason for this is that if an accountant is held responsible for the preparation of analyses, the performance of indicated verification procedures, or the writing of reports, changes subsequently considered ne-

cessary by his superiors after he has completed and signed for the work done should not be made without leaving evidence of the work he performed.

If an inexperienced junior inserts material in working papers which later investigation shows should not have been included, the deletion by crossing out is not always sufficient. Instead the superior should discuss with the junior why the information is unwarranted and then have the junior completely delete the information from the work papers.

In commenting on the often heard statement that too much time and effort are expended in review procedures, the author points out the obvious but sometimes forgotten fact that the reports rendered to the clients are normally the only tangible evidence of the work of the CPA which the client receives. The representatives of the public accounting firm may be at the client's office for weeks or even, in the case of some of the larger clients, months making an examination and when the engagement is completed all that the client receives for the considerable disruption of its accounting department, disturbance of its accounting and other personnel, and liability for an ofttimes substantial fee, may be a three-page report. Therefore, regardless of the number or types of reports rendered on an examination, it is esential that each be as accurately, lucidly, and informatively written as possible and contain not only all necessary information but also all such other material of an informative nature that will be of interest to the client and appropriately included in the particular report. To accomplish this, each such report and the related working papers must be reviewed carefully and completely by the most competent accountants in the public accounting firm.

SOME TAX STATISTICS

Some tax statistics of interest gleaned from recent Commerce Clearing House news releases:

The big news about state taxes is their size. In fiscal 1960 state tax collections rose to 18 billions, which represents a rather startling increase of 13.7%. As a result of this increase each man, woman and child in the nation, on average, paid a state tax of $101.72.

New York State tax collections of $1.96 billions was just below California's top of over $2 billions. On a per capita basis each New Yorker paid $118 while across the Hudson River the New Jerseyites each paid $60, the lowest per capita rate in the country. The great variance between states, it was reported, was due in large part to the extent that local governments assumed responsibilities for financing their own services, such as education, etc.

In the Federal tax field, the improvement in the Government's batting average in tax fraud trials has been noteworthy. In the last fiscal year only one out of ten indicted for fraudulently evading income taxes was able to avoid conviction — 1,079 convicted out of 1,194 indicted. In the same period jail sentences averaged more than two years each while fines averaged $2,289 apiece.

The indictments resulted from over 100,000 leads reported to the Intelligence Division of the Internal Revenue Service. They were sifted down to 15,041 cases, of which 3,561 led to full scale investigations.

REQUESTS FOR TAX BLANKS

Acting Regional Commissioner R. M. Horne, Internal Revenue Service, New York, requests CPAs to send in promptly their requirements for income tax forms.

This should be done on IRS Form 2333—request for Blank Income Tax Forms. Commissioner Horne reports that this form has been mailed to members of our Society. Shipments of orders will start about December 7, 1960.

Commissioner Horne requests that no inquiries regarding the status of an order placed with the Internal Revenue Service be made before December 23, 1960 in order to avoid duplication of effort. Check to be sure you have received and returned IRS Form 2333 to obtain your supply of Blank Income Tax Forms.

Letters to the Editor

FEE PITFALLS IN FIDUCIARY MATTERS

Those who did not attend the Wednesday morning session at Equinox during June, missed a very interesting and educational program. This session was under the auspices of the Fiduciary Committee, with Henry T. Kirkebye, CPA, as Chairman. The Committee presented a case study of a mythical estate, the Estate of Martin Taylor, showing what work would devolve upon the Certified Public Accountant if he was called in by the executors and attorneys for the estate. Facts and figures, as found in this estate, were presented on ten mimeographed sheets distributed to those who attended. The problems which they involved were then discussed and the four speakers presented solutions and suggested procedures to be followed. Every proposed step was supported by authorative references, and the veteran as well as the tyro in fiduciary work would have found much of benefit in a meeting of this type.

There was one aspect of the presentation, on which I would like to comment, as I believe that it has implications which affect not only the "Martin Taylor Estate", but accountants who engage in fiduciary work. It was stated in the distributed written material that the attorney for the estate had suggested:

> "That Mr. Joseph Holman, CPA, the decedent's accountant, should continue in the same capacity for the Estate. The executors approved. Accordingly, (the attorney) communicated with Mr. Holman, who agreed to maintain records for the estate and to prepare the decedent's final income tax returns, the estate tax returns, the fiduciary income tax returns and the financial schedules of the Account of Proceedings, and such other returns as might be required. He would also be responsible for overall tax planning."

The subject of accountants' fees has in recent years emerged from its chrysalis, and is now a fitting subject for open discussion by accountants, even to the extent of seminars on the subject under our programs of continuing education. Might not the subject of *collectibility* of such fees be also of equal importance? In my opinion, our Mr. Holman would run into trouble regarding his fees for the services he had rendered, if the executors claimed them as expenses of the administration of the estate, when they filed their Accounting. While other Surrogates might view it differently, there would be some questions if the Accounting was filed in the Surrogate's Court of New York County.

In the New York Law Journal of June 16, 1960, there appeared a decision by Mr. Surrogate DiFalco in the Estate of Henry Freudmann, which sheds some interesting light on judicial thinking on accountants' fees or compensation. This decision should be read because of its implications.

According to the Freudmann decision, there was before the Court an Accounting filed by the executors which probably was objected to either by some of the legatees or by the Special Guardian, particularly as to the payments made for accountants. The same thing could happen in the

"Martin Taylor Estate", because there were in that estate minors named as contingent remainder beneficiaries according to the testator's will, and undoubtedly a Special Guardian would be appointed by the Surrogate when the executors filed their petition to settle their accounts.

Surrogate DiFalco states in effect that the compensation allowable for accountants may be for "services necessarily requiring an accountant". Not all of the fees claimed for services rendered by the accountant were, under this interpretation, necessarily allowable as charges against the estate. He states that "Ordinary bookkeeping services should have been performed by the executors. The executors are required to keep adequate books and records and are compensated for such services through their commissions". Therefore, Holman, in the Martin Taylor Estate, would have had to collect personally from the executors for the services he had rendered "in maintaining the records". If he had billed the estate for them, the Surrogate would probably hold that the amount thereof would not be allowable. This should not cause surprise, because corporate fiduciaries, such as banks, trust companies, etc., when designated as executor or trustee, employ their own personnel for the keeping of all of the necessary records for the estate and make no claim for compensation for such work. They look to their commissions to compensate them for all of the bookkeeping expenses incurred by them for the estate. Individual executors, therefore, should not expect to be accorded a more favored treatment.

The Court found that "the services rendered in connection with the preparation, auditing and examination of decedent's income tax returns, and the preparation of statements in connection with various business enterprises were necessary and proper". While no mention is made of the fiduciary's income tax returns, such returns are income tax returns and probably there would have been no question that the fees for their preparation would be deemed proper charges against the estate. However, regarding the assignment to Holman of the preparation of the Estate Tax Return and the Account of Proceedings, there surely would be a question as to collectibility from the estate. These two matters have most frequently been held to be within the province of the attorney for the estate, if he claims compensation for his services in connection therewith.

If the accountant happens to prepare or assist in the preparation of the Estate Tax Return and Account of Proceedings, clarification or an understanding is necessary as to who would be liable for the fees for his services. In situations where the attorney takes the responsibility for the Estate Tax Returns, the accountant should arrange to be compensated by the attorney directly. There may be occasions where the executors specifically engage the accountant to prepare the Estate Tax returns, and the Estate's attorney has nothing to do with it, then in such a circumstance, the accountants' fee would be a proper charge against the Estate.

The Account of Proceedings presents an entirely different phase. It is basically a legal document, even though the bulk of the material it may contain consists of financial schedules. Accountants have often been engaged to prepare the financial schedules for the Accounting. Even if the executors engage him, the accountant should clarify who is to pay him for his work. Usually it may be the attorneys who will file the Accounting with the Court. However, it should be noted that an

executor of an estate is deemed to be an officer of the Court, and if he preferred, he could file his own accounting without the intercession or assistance of an attorney. Perhaps in such a case, it would be my opinion that the services of the accountant in the preparation of the financial schedules might be a proper charge against the estate. But even in this area, there are some doubts. It is interesting to note another recent decision of Surrogate DiFalco on the matter of accounting fees. In the case of Matter of Estate of Julius Feinberg, Deceased, decided December 17, 1959, the Court held that the fees for an Accounting submitted by the trustee was not an allowable charge against the income of the trust. According to this decision, the trustees should have paid for such services out of their commissions.

Accountants' fees for the preparation of financial statements for business enterprises conducted by the executors appear to be allowable as proper expenses of the estate. Also, the operation of rental properties would probably fall into the category of business enterprises. In another area, where accountants perform services, there may be a question as to who would be chargeable for the compensation due to the accountant for the preparation of annual or other periodic reports of estates or trusts. In the booklet issued by the American Institute of Certified Public Accountants, entitled "Special Reports—Application of Statement on Auditing Procedure No. 28" are presented some examples of reports (opinions) to be appended to financial statements prepared by accountants for executors, administrators, trustees and guardians to be filed with the courts and beneficiaries. Who is liable for the fees in such cases? It is my opinion that in situations where the accountant does auditing work on the records kept by others, either for the information of the executors of a large or complicated estate, and where he renders his report to the executors, or the beneficiaries of the estate or trust, that the accountants' fees are a proper charge against the estate or the income of the trust. The reason for the applicability of the charge may depend upon the nature of the work and whether the services were those "necessarily requiring an accountant". If it was of a truly professional nature calling for special training experience and judgment, it should be chargeable against the estate.

Before concluding, I wish to call attention to one portion of Judge DiFalco's decision which should be heeded by all accountants engaging in fiduciary work. The Court was critical of the accountant in the case, because he was unable to allocate the time spent to the various items of service. The accountant had testified only to the total number of hours expended. He was unable to allocate the time spent to the various items of service. It may be considered advisable that when an accountant is engaged upon a fiduciary matter, he should from the outset keep a diary or other form of time record showing the dates when the work was performed, a full description of what was done, and the time spent on each item of service. The more detailed the explanations of what was done, the better. Accountants may well copy a page from the attorney's book, in this respect. They include every telephone call they make, every letter they write and everything else they do for the estate. When the accountant's bill is to be submitted, either the full details should be sent to the client for his information, or such details can be embodied in an affidavit to be submitted to the Surrogate, if the bill happens to be questioned. The Surrogate seems to be

inclined more favorably to a complete workmanlike presentation of the facts regarding the accountants' services. Of course, it is always helpful to have an agreement as to the rate of charge for the services before hand. If this was not done, then the procedure requires that the bill be considered on a "quantum meruit" basis, and the accountant may be at the mercy of the Court.

I hope that Holman in the Martin Taylor Estate had no trouble in collecting his fees, either from the estate, its executors personally, or from the lawyer. But if he did not tell them in advance that there were differences to be resolved as to who was liable and they paid the fees out of the estate funds, then they might be resentful, especially if the Surrogate subsequently surcharged them for a portion of the fees paid to him when the Accounting was before him for approval.

JOSEPH GETZ, CPA
(*Joseph Getz & Company*)
New York, N. Y.

ADDENDUM TO J. K. LASSER BIOGRAPHY

It has been pointed out that the biography, "J. K. Lasser" (July, 1960, The N.Y.C.P.A.), written by me, made no mention of Lasser's association with the Tax Institute, Princeton, New Jersey.

So, for the record, let it be noted that Jacob Kay Lasser rendered to the Tax Institute during the period December, 1941 to May, 1954 the following service: Bookshelf Committee, 1944—May, 1954; Membership and Finance Committee, 1945-1948; Panel Committee, 1946-1951; Development Fund Committee, 1951-1953; Advisory Council, 1945-1947; Board of Directors, 1945-1947; Treasurer, 1948; President, 1949.

HENRY LIEBERMAN
Chairman, History Committee
The N. Y. State Society of CPAs

Book Reviews

PROFESSIONAL NEGLIGENCE

By Thomas G. Roady, Jr. and William R. Andersen, VANDERBILT UNIVERSITY PRESS, Nashville, Tennessee, 1959, 1960. Pages: v + 332; $10.00.

The Vanderbilt University School of Law has added a much needed volume to the growing literature relating to the liability of professionals in connection with the practice of their callings.

The introduction succinctly expresses the growing problem of the professional man in facing actions for negligence resulting from the increased numbeı of such claims. It also points up the ethical and moral problem of practitioners in the various professions in prosecuting, defending and, most importantly, testifying as witnesses in such actions. One can only agree that professionals must be prepared to appear in such actions as witnesses for plaintiffs if the circumstances, in their professional judgment, warrant such appearance.

Professor Carl F. Hawkins, the author of the article, *Professional Negligence Liability of Public Accountants,* has made a useful analysis of the cases relating to the liability of public accountants to their clients by grouping them according to the types of situations in which such liability may arise. The types of situations are grouped as: (1) erroneous reports, (2) failure to discover defalcations, and (3) tax related situations.

In recognizing the fact that clients do rely on public accountants for the discovery of defalcations, the author has not commented on the recent Cereal Byproducts case (*Cereal Byproducts Co.* v. *Hall,* 132 N. E. 2d 27 (App. Ct. Ill. 1956), aff'd 155 N. E. 2d 14 (Sup. Ct. Ill. 1959); 147 N. E. 2d 383 (App. Ct. Ill. 1958), aff'd 155 N. E. 2d 14 (Sup. Ct. Ill. 1959)). There, the court expressly recognized the public accountant's obligation to make certain examinations or checks which might be expected to reveal the existence of defalcations. The court did not, however, make any attempt to identify the examinations or checks which it felt should have been made in that case or, indeed, in similar cases. The court was obviously faced with the very problem the public accounting profession faces in attempting to delineate more specifically the area of such examinations.

On the question of whether actions against public accountants rest in breach of contract or in tort, the author seems to conclude that it makes little difference on which theory such actions are commenced. Such conclusion fails to take account of the far-reaching legal consequences of the choice of theories. The fact is that the plaintiff in the ordinary case would appear to have no choice as to the theory on which such action may be brought, but is relegated to an action sounding in tort, *i.e.,* an action for negligence.

It has been recently held (*Carr* v. *Lipshie,* 8 App. Div. 2d 330, 87 N.Y.S. 2d 564 (1st Dept. 1959)) that an action against a certified public accountant for failure to discover defalcations where he was retained to make an ordinary examination is an action for negligence, sounding in tort, rather than in contract and is, therefore, subject to the shorter statute of limitations applicable to negligence actions. The effects of this holding, if generally followed, in limiting the possible liability of a public accountant, are obvious.

Further, it has also been held that a plaintiff in an action against a public accountant does not escape the bar of the shorter statute of limitations applicable to negligence claims by pleading gross negligence which might permit the jury to draw the inference that the public accountant was guilty of fraud (*Peerless Casualty Co.* v. *John Forbes & Co.,* Civil Action No. 36,494, United States District Court, N. D. Cal., 1957). In that case, the court there held that the longer statute of limitations applicable to fraud actions related only to situations where there was a pleading of an affirmative fraud on the part of the defendant.

Mr. Saul Levy, in a review which appeared in the September issue of the Journal of Accountancy, reviewed at length the author's analysis of the *State Street Trust* case and differed with the author's interpretation of the case. I would have to join in the position taken by Mr. Levy, since *State Street* does not change the rule insofar as it relates to the pleading and proof of a claim brought by a third party against a public accountant alleging the existence of fraud. *State Street,* as does *Ultramares,* (*Ultramares Corp.* v. *Touche,* 255 N. Y. 170 (1931)) would permit recovery only where there is proof of gross negligence which would permit the jury to draw the conclusion that the public accountant had shown reckless disregard for the facts in expressing his opinion on the fairness of the client's financial statements.

It must be concluded that Professor Hawkins' article does make a notable contribution to the all too sparse literature on the liability of public accountants. It demonstrates, as does the entire volume, the growing tendency on the part of the courts and the public to hold professionals liable, at least for negligence if not as insurers or guarantors, in connection with their rendition of professional services.

THOMAS W. HILL, JR., CPA
(*Spear and Hill*)
New York, N. Y.

THE PRESIDENT'S PAGE

Our Chapters

One of the pronounced fringe benefits that have accrued to me, in common with my predecessors, as President of the Society, has been the opportunity to meet with Chapter members and their officers. I have also been privileged to observe some of the Chapter committees in action.

It has been most inspiring to join with the Chapter officers, help formulate their plans, enjoy the satisfaction resulting from their progress and, most important of all, to encourage them in serving their members and the community.

Chapter members, as well as other members, constitute the grass roots of our Society. Their participation at every stage of the profession's progress is vital. Indeed, in their respective areas, Chapter members often must lead the way on many an important occasion.

Seven of our ten Chapters are sufficiently far from the New York City Metropolitan Area, and from one another, that a good measure of self-reliance has necessarily developed. The same self-reliance is evidenced by the near-by Chapters. This development reflects the training and the very nature of the CPA.

We need not turn back the years to recite with pride some of their outstanding accomplishments. A roll of honor is in the making day by day. Through the initiative of an active and enterprising member of the Rochester Chapter, arrangements were made for the first printing and distribution in New York State of the leaflet "What's in a Name." Its reception has been enthusiastic, to say the least. Westchester, Utica and other Chapters

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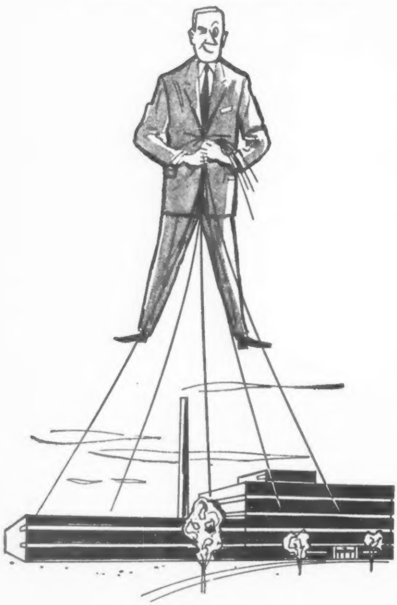

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have performed heroic and yeoman service through their Committees on Emergency Assistance in preserving the practice of ailing and deceased members.

Only limitations of space prevent the listing of comparable achievements of other Chapters, also with unusual benefits. In fact, we no longer regard such performances as extraordinary. Practically every Chapter has presented or planned constructive meetings in the professional and public interest. All have participated actively in developing the proper public image of the CPA.

Some of our Chapters are comparatively small. Yet absence of size has not curtailed or dimmed either their efforts or enthusiasm. Other Chapters are larger than some State Societies. Some have developed and carried through programs to which we can point with pride as criteria to be followed, not only by other Chapters, but also by both our Society and other Societies at the state level.

In the membership area, too, our Chapters have done at least their share, if not more, in interesting both new and old CPAs in the advantages of joining the Society and maintaining activity. On the committee level, it is not unusual to find—particularly in the smaller Chapters—a majority of the Chapter membership exceptionally active in the work of the Society.

The visits which the officers have made to all the Chapters, in conjunction with the practical experience of the Chapters Operations Committee, have enabled a degree of coordination and cooperation which has brought to our entire membership, not alone the Chapters, a maximum of benefit.

All told, we have just cause to be proud of our progressive Chapters. In turn, they must continue their record of achievement and progress. They cannot rest on their laurels. I am confident that our Chapters can be relied upon to do their share in the forwarding and attainment of the aims of the profession and of our Society.

BENJAMIN GRUND,
President

Current Federal Tax Developments

By HON. DANA LATHAM, Commissioner of Internal Revenue

INTRODUCTION

I am happy to have this opportunity to join you this evening for what I have been told is a "strictly business" meeting. I must confess that this is to my liking, since appearances of the after-dinner type are rather hard on a Commissioner unless the audience is interested in taxes. So I can speak seriously to you tonight, secure in the knowledge that my interest in taxation is matched, if not exceeded, by your own.

In this connection I don't need to tell you it isn't easy, at least for me, to treat taxes in a light vein. This is true even though taxpayers such as the New York housewife, of whom you recently read, occasionally do such things as claim 19 dependents and then wonder why we suggest that a grand jury should look into her case. I am sure that you heard of the undertaker's wife who deducted the cost of her groceries as a business expense. When asked for an explanation she calmly told our representative that the grocer was a potential customer and she was building good will.

I enjoy talking with accountants. I number accountants among my best friends. I regard the CPAs of the United States as the members of a proud profession. They have made contributions of real value to the Internal Revenue Service. To a man, we know that any reasonable request for assistance and advice will be instantly honored. We are always certain that the views expressed will be sincere and objective. Because of its make-up and proximity to Washington, we are especially indebted to the New York State Society. In behalf of the entire Treasury Department and the Internal Revenue Service may I thank you.

I was quite pleased to see that the subjects Mr. Grund suggested as perhaps suitable to this occasion include those which had occurred to me. It is good to start out with such a meeting of the minds. Accordingly, I will review a few of these subjects with you, with special emphasis upon recent developments of interest to practitioners with accounting backgrounds. But first, since I come to you as a lawyer by profession, it occurs to me that my thoughts with respect to the roles of the accountants and lawyers in the administration of our tax laws may be worth brief mention.

DANA LATHAM, took the oath of office as Commissioner of Internal Revenue November 5, 1958. He served his first term with the Revenue Service in 1926 and 1927 when he was a special attorney in Washington and San Francisco. As Commissioner and chief officer of the Internal Revenue Service, Mr. Latham develops the policies and administers the activities of the Service under the Secretary of the Treasury. This article has been adopted by the author from a paper presented at the October 4, 1960 General Meeting of the Society.

ROLE OF ACCOUNTANT IN TAX PRACTICE

During most of my business life, I practiced "tax law," in association with both lawyers and accountants. At the risk of being accused of rank heresy, I can say that this experience has convinced me that tax practice is, within limits, properly within the scope of both professions. I say this even though I am keenly aware of the fact that the preparation of even the simplest tax return involves important questions of law and fact.

In the past I have been active in attempts to delineate the respective roles of the lawyer and accountant in this area. I have served on committees of accountants and lawyers charged with that responsibility. For at least two years I served on a California State Bar Committee which worked with a California State Society counterpart committee chaired by my good friend Lou Penney. I am of course familiar with the tremendous service performed in this field on a national level by your own John Queenan.

These experiences, plus what I've learned as Commissioner, have taught me that efforts to rule out either group are undesirable, impractical, and unnecessary.

As a matter of fact, in an appearance before the California State Bar Convention just a few days ago my sentiments on this subject were put to a severe test. I was asked the following two questions:

> "If the general practitioner seeks help from a tax specialist, is it proper for him to refer all such matters to an accountant?
>
> "If it is not proper to refer all tax matters to an accountant, how does the general practitioner recognize those tax problems which should be referred to another attorney who specializes in tax matters?"

Without intending, may I assure you, to be either facetious or irreverent, I could think of no better answer than that made some 2000 years ago to the Pharisees.

> "Render therefore unto Caesar the things which are Caesar's and unto God the things that are God's." (Matthew 22:21)

It is quite obvious to me that there are important places for both the accounting and the legal professions in the tax field. As a matter of fact I think much progress has been made in achieving harmonious working relationships between these two great professions, and I would urge all members of the Bar and of the accounting profession to understand and value the benefits of cooperation.

Certainly, the accountants and lawyers on the Commissioner's Advisory Group get along well together, as Tom Graves can attest. Speaking of the Advisory Group—which is, as you know, a body of 12 distinguished tax practitioners with whom we meet periodically to explore ways in which the Service can improve its operations —it has made invaluable contributions to the development of each of the programs I will be talking about this evening. Here and now, I want to acknowledge our debt to the members of this Group.

Let me turn now to these programs, the first of which is our effort to curtail abuses in the expense account area.

EXPENSE ACCOUNTS

I suspect that many of you probably do not entirely sympathize with our efforts in this field, but I do think you ought to know what we are trying to do, and why.

Probably most of you know that in June the Senate actually passed a bill (and this was not the first attempt to

limit, by statute, business expenditures) that would have drastically affected expense account deductions. The bill was so short and sweeping that I can easily read it. It provided that no deduction shall be allowed for any expense paid or incurred for:

"(1) entertainment (unless entertainment is the trade or business of the taxpayer and the expenses are paid or incurred to further such trade or business) except that the expenses paid or incurred for food or beverages for the primary purpose of providing an opportunity to advance the trade or business of the taxpayers may be deducted, if such expenses would have been deductible prior to the enactment of this subsection;

"(2) gifts, except that any gift by the taxpayer in the course of his trade or business to any person may be deducted in an amount not exceeding $10 per person per year, if such expenses would have been deductible prior to the enactment of this subsection; or

"(3) dues or initiation fees in social, athletic, or sporting clubs or organizations."

This provision, I repeat, was passed by the Senate, and it was eliminated in conference *only* after an agreement was reached to substitute a section which provided (1) that the Secretary of the Treasury would report to Congress the results of the enforcement program the Internal Revenue Service now has under way, and (2) that the Joint Committee on Internal Revenue Taxation would also make a complete study of the operation and effects of the present law, regulations and practices in this area.

In view of this mandate from the Congress, it seems to me that the Service has a clear obligation not only to report on the results of its enforcement program in this area, but also to do all in its power to make the present system work; the less statutory law the better.

Naturally, one of our basic goals is to encourage taxpayers to keep adequate records and supporting documents on travel, entertainment, and similar expenses. Thus, whenever we find that the taxpayer does *not* maintain adequate records of business expenses, the District Director will send him a letter calling attention to this fact, and informing the taxpayer how to *correct* the deficiencies in his record keeping. *The taxpayer will also* be told that if he *fails to maintain adequate records in future years,* the allowability of his deductions will be determined under a more strict standard than the Service applied *in* the *current examination.*

Now, I suppose these letters will inevitably be called "warning letters." I think that term has unfortunate connotations. We prefer to think of them, literally, as admonishments which put a taxpayer on notice of his duties under the law and regulations.

I should make it clear that announcement of this new program does not mean that we will not make such corrections as may be necessary during the first examination of the taxpayer; for, obviously, we cannot give a taxpayer license to overstate his expenses even for one year. The same criteria will be used during the first examination as we have used in the past in determining the allowability of deductions for business expense. However, after the taxpayer has been specifically put on notice of what should be done to comply with the law, it seems to me we have every right to apply a more strict standard in cases where business expenses are still not properly substantiated.

I hope that practitioners and busi-

nessmen will recognize that the Service's efforts in this area deserve their cooperation rather than their criticism. We are not engaged in a witch-hunt nor a wild-eyed effort to reform the business community. Our agents have been instructed to proceed with practical common sense, and an awareness of normal and legitimate business practices. They have been specifically cautioned to avoid arbitrary disallowances and an unreasonable approach. We think that our program in this area merits the support of all of those who are interested in fair and effective administration of the existing laws.

DIVIDEND AND INTEREST PROGRAM

Another program of significance undertaken during the past year was the Treasury's campaign to close what has been termed the "dividend and interest gap." The background is this. Estimates made independently by both the Internal Revenue Service and private research groups indicated that there was a substantial difference between the amount of interest and dividends reported on income tax returns, and the amounts actually paid out. While much of the difference could be attributed to the $50 dividend exclusion, the fact that many recipients are not subject to tax, and similar factors, it is clear that this is not the whole story. Our estimates were that approximately $1 billion in dividends and more than $3 billion in interest remained unaccounted for. These figures represent a tax loss of at least $500 million annually. To meet this problem, a program with both educational and enforcement aspects was undertaken.

We have no doubt that much of the gap is due primarily to misunderstanding of the law, inadequate records by recipients, and pure oversight. Consequently, there was launched an extensive educational campaign designed to inform taxpayers of the taxability of such income, and to see that taxpayers were supplied with specific information with regard to the amounts of dividends and interest paid to them.

The cooperation given us by payers of dividends and interest was most impressive. A coordinated information campaign was undertaken by the principal associations of dividend and interest payers and by tens of thousands of corporations, banks, and individuals who make such payments. Our estimates indicate that more than 75 million special notices were mailed to recipients of dividends and interest. As a result, we are confident that very few dividend and interest recipients have failed to receive one or more notices.

We also made a number of changes in the tax forms and instructions in order to emphasize the requirements concerning the reporting of dividend and interest income. We also developed a good deal of filing publicity on the subject and took a number of other such steps.

To implement the educational campaign, the Internal Revenue Service also undertook a vigorous enforcement campaign designed to detect and punish persons who were knowingly failing to report dividend and interest income. Probably the most important of these was an expanded program for checking Forms 1099 (which, as you know, are the reports we receive from payers of dividends and interest) against the returns of individual taxpayers. The Service receives over 100 million of these 1099's each year, so it cannot presently check them all. Consequently, the 1099's received have always been checked against individual tax returns on a sampling basis.

However, in connection with our dividend and interest program, we substantially expanded this matching

program in every one of our 61 Districts throughout the nation. Follow-up audits were made in cases in which a return had not been filed or where additional taxes appeared to be due.

As a result of our routine procedures, plus these special efforts, some 300 prosecution cases involving failure to report dividends and interest were undertaken and are now in process. In recent months, 31 convictions have been obtained in such cases, resulting in the imposition of fines ranging up to $20,000, and imprisonment in a number of cases.

While we cannot yet fully measure the results of these efforts, indications are that they have been quite successful. We have received most of the results from the check of approximately 2,000 individual cases that were selected as a result of a screening of approximately 100,000 returns. In each of the cases selected, the information returns indicated that the taxpayer may have failed to report dividend or interest income in full in a prior year (1958).

We have now received audit reports on 1,801 of the 2,000 cases selected. If this admittedly small sample is typical, it would suggest that our program was amazingly successful. The number of taxpayers who failed to fully report dividend income in 1958 decreased by 50% in the following year, and the amounts of money unreported decreased by approximately 45%. The number of taxpayers who failed to fully report interest income in 1958 decreased by 47% in the following year, and the amount of under-reported interest decreased by approximately 48%.

I want to emphasize that while these figures are based on an extremely small sample, they give us reason to believe that our efforts are meeting with success.

I am sure you know that there has been considerable sentiment in Congress for a statutory withholding program covering dividends. You also are aware of the fact that such a requirement would impose rather substantial burdens on all dividend payers and many taxpayers. It would also materially increase the administrative problems of the Revenue Service. Consequently, we would hope that withholding could be postponed at least until the results of our educational and enforcement campaigns in these areas can be fully evaluated.

REQUESTS FOR EXTENSIONS OF TIME

Another matter that I would like to discuss with you is the volume of requests for extension of time for filing individual returns—which, until recently, was reaching wholesale proportions. In 1959, for example, we received over half a million such requests. Often, the preparer made the application in his own name and attached a blanket list of names, in some cases as many as a hundred or more.

More seriously, there were indications that extensions for filing were being sought by some people whose real purpose was to delay paying their taxes, and by others who thought—mistakenly, I might add—that they might thereby avoid an audit. The granting of extensions in such large numbers was also becoming a significant problem in our returns-processing work, especially as we have shifted more and more to the use of high-volume equipment for the processing of returns. Even more importantly, we feel that fairness to the tens of millions of taxpayers who do file their returns on time compels the Service to grant extensions only when they are genuinely needed—that is, where the delay in filing is actually due to unavoidable or unexpected circumstances.

As you know, just prior to last year's filing period, we adopted new regulations which, simply stated, make each extension request stand on its own merits. The taxpayer is now required to tell us why he needs an extension, and for how long, and to give us a few simple facts about his past filing and payment record. Internally, we also strive for a uniform policy in regard to the granting of such requests.

As a part of this policy, Districts were reminded that the duty of filing a return is imposed by the law on the taxpayer himself. Therefore, any extension which may be granted runs to the taxpayer, rather than to the practitioner, and it is only proper that the Service look to the taxpayer rather than the tax practitioner in determining whether there are factors present which may reasonably be regarded as justification for the granting of an extension.

The Service's efforts to discourage the submission of extension requests based on frivolous or inadequate grounds were highly successful. The volume of requests dropped this year from over one-half million to approximately 375,000. And contrary to the impression that we had tightened up our policy to an unreasonable degree, our statistics reveal that, on a nationwide basis, three out of four requests for extensions were granted. Although it may seem paradoxical, our ultimate goal is to grant *all* requests for extension, on the theory that once our requirements are well understood and observed, only bona fide requests will be submitted.

Now, early in this program we took the position that a taxpayer who was unable to get needed assistance in preparing his return, despite timely and reasonable efforts to obtain it, would have his extension request granted. At the same time, however, we said that the accountant's inability to prepare timely returns because of volume of work would not, *in itself,* be considered sufficient reason for granting an extension.

A number of societies of tax practitioners and numerous individual preparers took this to mean that the Service was turning its back on the problems of conscientious but overburdened practitioners. Needless to say, we were very sensitive to this suggestion.

Our people have been busy over the last few months trying to resolve this problem. In recent weeks, we met with representatives of the AICPA to see whether we could not agree on an official pronouncement that would help clarify the Service's position on this point. I am happy to say that these meetings seem to have borne fruit, and the Service plans to publish in the Internal Revenue Bulletin [Ed. Note: Nov. 7, 1960 issue], a statement that we hope will clear up the misunderstanding on the burden-of-work issue.

Let me give you an idea of the lines along which we are now thinking: First of all, our policy was never intended to mean, and should not be construed as indicating, that the practitioner's workload can never be an acceptable reason for granting an extension. Such a position would be as arbitrary and unreasonable as one which holds that the practitioner's workload should always be an acceptable reason. We realize that, despite the best efforts of practitioners to schedule their work in such a way as to complete all of it by April 15, there will always be some situations in which a particular practitioner is unable, for reasons beyond his control, to complete one or more returns for filing by the due date. The unavoidable or unexpected delay could be attributable to one or more of a number of happenings. For example, the practitioner or

members of his staff might become ill for a sufficient period of time to cause some appreciable disruption in his work schedule. It might develop that some of the returns involve more complicated problems than first appeared to exist. The taxpayer may have been unable to get needed assistance in preparing his return despite timely and reasonable efforts to obtain it. This might be due to the fact that there are not enough practitioners in the small town or other community where the taxpayer lives to meet the needs of the public by the due date, despite long hours of overtime work.

This recognition by the Service that the practitioner's workload in certain circumstances can have a material bearing on the acceptability of an extension request does not, however, relieve the taxpayer from making a clear showing in his application that he has made reasonable efforts to file his return on time but finds himself unable to do so because of reasons beyond his control.

It is my hope that this clarification will meet the concern some of you have expressed and that, working together, we will be able to assure the continued success of the program without hardship on anyone.

EVALUATION OF REVENUE AGENTS' PERFORMANCE

Now, let me turn to our new evaluation system for Revenue Agents.

One of the oft-recurring rumors or allegations about the Service over the years has been the assertion that Revenue Agents are rated according to the amount of additional tax they propose for assessment.

This attitude has troubled us very much because it is *not* true, and because it runs counter to our basic philosophy of proposing for assessment only the tax due under the law—not a penny more or less. Our internal instructions have long prohibited such a practice. For years, my predecessors and I have issued personal statements on this subject. Yet the belief has persisted.

We determined, therefore, to get at the root of the problem and decide what, if anything, we could do to correct this impression that our Agents are rated on the basis of dollar production.

The first thing we found was that there was a general lack of uniformity throughout the country in the evaluation of Revenue Agents. Each District Office seemed to have its own system. Furthermore, the Group Supervisor—the person who actually evaluates the Agent—had no clear guidance from the National Office as to how he should go about evaluating the Agent's performance, and what specific factors he should take into account. So perhaps there *was* a tendency for some District Offices to go astray. In any event, emphasis on production as an end in itself, could have occurred in some cases.

I should like to take a few moments to tell you how we are trying to eliminate this possibility through our new nationwide performance evaluation system for Revenue Agents.

First, as I indicated at the outset, this is an area in which the members of the Commissioner's Advisory Group have taken a keen interest ever since our first meeting in June 1959. We have discussed it at every meeting of the Group and have had the benefit of the members' criticisms and suggestions as our system of evaluation gradually evolved. The Group's contribution in this area has been truly outstanding.

I don't need to tell those of you who have tried to evaluate professional colleagues that the problem is substantial yet subtle. If you evaluate a man on his qualities, you focus attention on

those; if you evaluate his *production* and look at his general qualities only if his production is low, you give him the impression that if his production is high, no questions will be asked about these basic qualities. One of the main reasons, then, for avoiding direct calls for increased production is that they do nothing to cure the deficiencies that *cause* low production.

Recognizing this paradox, our approach has been to require supervisors to genuinely know the abilities of each man, to identify any deficiencies he has and to focus attention on them. To enable the Group Supervisor to do this, we are installing a system that:

(1) Outlines the methods and techniques the Group Supervisor should use in guiding and evaluating employees;

(2) Stresses that the Group Supervisor must know the work habits and abilities of his men so well that he does not need to rely on statistics in order to arrive at a judgment;

(3) Emphasizes that statistics—for example, number of cases completed, amounts of additional tax assessed —are to be considered solely as symptoms; and

(4) Provides for a continuing appraisal of the agent's work by the Group Supervisor in order that he may correct deficiencies and observe strong points on a day-to-day basis.

In addition, we are providing for training and follow up procedures to insure that Group Supervisors properly apply the new rating system.

As a further indication of our determination to deemphasize statistics, we have eliminated entirely the time-honored numerical ranges of performance—which some have interpreted as "quotas."

Time does not permit me to go into further detail, but I would not wish to leave this topic without mentioning the three elements on which we will hereafter rate Revenue Agents. These are: (1) ability to recognize and develop issues, which includes such things as pre-examination planning and raising issues of tax consequence; (2) ability to report facts and conclusions, including explanations of adjustments to taxpayers; and (3) "Non-Technical Elements," such as *courtesy and initiative.*

We all feel that this new evaluation system represents a major step forward by the Service. I trust you will share our conviction as you have occasion to observe its effects in the years ahead.

INFORMAL CONFERENCES

As you know, informal conference procedures are an integral part of our audit and settlement program. To me, it is of paramount importance not only that tax controversies be disposed of expeditiously but also that the number of cases going on to Appellate and the Tax Court be held to a minimum. We have found that a hearing by the agent's group supervisor, or another group supervisor in the office, is the most appropriate way of resolving disputed cases involving questions of fact, where the issues are not particularly complex. The typical informal conference can be granted promptly and without the necessity of formal briefs or representation. In the small tax cases, particularly, it has many advantages.

Despite the strong points of the informal conference procedure, we encountered a reluctance to use it in the part of some practitioners. As a result, we held a series of meetings throughout the country to discuss existing procedures and problems, and

the principles that should be followed in these conferences.

These meetings and our other studies convinced us that there were two major deficiencies in our procedures: (1) We found that many taxpayers and practitioners were not availing themselves of the informal conference procedure, largely because — rightly or wrongly — they felt that the group supervisor of the agent who handled the case would not be sufficiently impartial; and (2) on complex cases we found that the group supervisor did not have sufficient time to fully prepare for and hold the conference without neglecting his other duties. We determined, therefore, that a number of changes should be made in existing procedures. These were publicly announced recently, and perhaps you have already seen them. In any event, I will hastily summarize the major changes:

1. A conference coordinator position will be established in each District which did not previously have one. Additional full-time conferee positions will also be established in Districts having sufficient workloads to justify them.
2. Informal conferences in complex cases will normally be handled by the conference coordinator, a full-time conferee, or a qualified technician in Audit who has been selected by the coordinator to hold a particular conference.
3. In the less complex cases, the taxpayer will normally be offered a conference with the examining officer's group supervisor, as in the past, but he will also be offered the option of a conference with a conferee who functions independently of the examining officer's group supervisor. The purpose of this change, of course, is to permit a taxpayer who feels that the agent's own group supervisor might be biased to hold his conference with someone else.
4. In the conference invitation letter used in complex cases, the taxpayer will be requested (but not required) to submit an informal written statement setting forth his position relative to the issues involved. Our experience has shown that such statements often contribute to better identification of the areas of agreement and disagreement and to earlier resolution of disagreements.

In addition, we have taken several other steps designed to maximize the effectiveness of our informal conference procedure. One of these is to provide for a review by the District Conference Coordinator of all cases in which agreement was not reached at the informal conference, and in which the taxpayer has filed a protest. The objective of this review is to identify any cases in which further settlement efforts might be productive. Moreover, a second review for the same purpose is performed when the case arrives at the Appellate Division. Thus, we are attempting to make sure that cases do not reach the Appellate level unless they genuinely need to go there. In the Regions in which these procedures were first installed there has been a very noticeable reduction in the flow of cases to Appellate. I am sure we can all agree that this is beneficial, since it is obviously desirable that tax disagreements be settled at the lowest feasible level.

CONCLUSION

Again, may I thank you for your wholehearted cooperation and unselfish service. We aren't perfect and certainly never will be. I feel, however, that we are making some progress. We shall always need your advice and assistance.

Accounting for Rent Escalation Under Long-Term Leases

By Roy A. Paul, CPA

The trend towards long-term leases, in lieu of the purchase of large properties, has served to focus increasing attention on the major accounting problems raised by this type of business arrangement. One problem is the accounting control of the expense factors involved in the rent escalation provision. Herein are described the basic records that must be established at the inception of a lease, and the procedures to be observed annually thereafter.

It is not the purpose of this discussion to remotely suggest encroachment upon the domain of members of our brother profession but to bring to light certain problems that are arising in the process of examination of financial statements and the rendering of opinions by independent public accountants, particularly with respect to clients' current and contingent liabilities under long-term leases.

MODERN TRENDS IN LEASING

As a result of several large mergers during the past few years and the consolidation of offices and salesrooms under a single roof, in order to control administrative and indirect expenses of operation, a general trend has developed whereby corporations will lease a number of floors in a newly, modern air-conditioned office building for an extended term of years. Many of these corporations lease greater areas than are currently required in order to provide space for future expansion programs. Sub-leasing of this extra space for short-term periods until needed reduces gross rentals to normal on a net basis. It is practically axiomatic that the tenant who leases the most space in a newly constructed office building is privileged in having the building bear its name, which lends a measure of prestige to both the structure and the tenant.

Heretofore, a landlord, in calculating the expected return on his investment, after having considered his cash outlay for interest and amortization of indebtedness, had relied upon an adjustment of rents to meet increased costs of operation; such adjustments being effected under renewals of short-term leases with corresponding rental increases.

Today, in leasing large areas of a new building for long-term periods, a landlord must, of necessity, include in the leases provisions for adjustment of

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rents by means of Escalation which in principle enables the landlord to match increased costs of operating the property (after a basic or normal operating period) with a proportionate increase in rental revenue over the term of the lease. Likewise, a decrease in operating costs would result in a reduction of rents for the period, thereby granting to the tenant the same benefits as provided for the landlord under changing economic conditions.

RENT ESCALATION PRINCIPLES

An universally accepted lease clause defining escalation of rents has not as yet been formulated and perhaps is not possible as landlords and tenants, when negotiating a rental rate, will determine for themselves what items of expense are to be included or excluded in both the basic year (or years) of operation and the succeeding years during which tenants share by means of a rental adjustment, in the increased or decreased costs of operating a building.

A "Base Period" is sometimes defined as the first twelve-month period commencing on either a January 1st or July 1st during all of which period a substantial portion of the net rentable area of the building shall have been occupied by tenants under leases. In some instances this Base Period may be considered a two or three year period, in order to establish an average annual cost for operating the property in lieu of the initial twelve-month period. These costs are termed Base Period Operating Costs. In cases where real estate taxes are considered a separate item for escalation, a Base Period for Taxes will be determined as above, and will usually encompass a period coinciding with the tax-year of the particular locality; e.g., July 1st to June 30th in New York City.

A "Lease Year" is sometimes defined as each twelve-month period commencing on each anniversary of the commencement of the Base Period. If the latter includes a period longer than twelve months, the Lease Year will begin on the day following the expiration of the Base Period.

COST ITEMS APPLICABLE

Items of operating cost for inclusion in Base and Lease Year periods are usually enumerated in the lease and include substantially the following:

1. Salaries of superintendent and staff or management fees of managing agent, if no superintendent is employed.
2. Salaries and other compensation for accounting and clerical employees, the building's departmental supervisors and assistants.
3. Wages of general operating staff such as elevator operators, janitors, porters, window cleaners, electricians, carpenters, engineers, plumbers, elevator mechanics, etc.
4. Payroll taxes and employee benefits.
5. Repairs and maintenance costs, including supplies and materials and cost of outside services.
6. Insurance premiums usual to the operation of a building.
7. Utilities: fuel or steam, electricity, water charges and sewer rents.
8. Other costs related specifically to operation and maintenance.

Items of exclusion consist principally of those costs which have no direct relation to operation and maintenance such as ground rent, capital expenditures, advertising and promotional, leasing costs and the like.

BILLING PROCEDURE

Rent escalation is billed to tenants in amounts directly proportionate to the square footage of the rental area occupied by the tenants to the total rental area of the building. Thus, a tenant occupying 250,000 square feet

in a building measuring 1,000,000 square feet of total rental area, would share in 25% of the increases or decreases in operating costs. Usually, ground floor tenants who furnish their own cleaning services are exempted from rent escalation since store leases generally provide for additional rentals based upon a fixed percentage of sales or profits, with or without a guaranteed fixed minimum rental as provided in the lease agreement. It follows, therefore, that the landlord's share in the increased operating expenses of the building is the proportion of the total area occupied by the stores to the total rental area of the building.

Excluded from total rental area are ground floor lobby, maintenance, locker rooms, storage and shop areas, public halls and corridors (not rented as part of a complete floor), elevator and dumbwaiter shaft areas and similar space.

INTERPRETATION OF LEASE CLAUSES

The determination of the extent and limitation to which items may be included for escalation is a subject of tremendous importance to accountants who may be called upon to certify or to review and render an opinion on the figures upon which additional rent is predicated.

Some leases are written in general terms defining the extent increased costs may be billed to tenants with the result that invoices are merely rendered for tenants' shares of the amount by which Lease Year costs exceed the Base Period costs, thus presenting no great accounting problem.

However, other leases may be more specific in this determination. An extreme example is as follows: "In computing Lease Year expense any operating cost (whether major or minor and whether being, or forming part of, a group, or classification of items or things, or comprising only a single item or thing, however large or small) of a kind properly includible in Lease Year expense, but of a kind which either was not incurred or was not incurred to as great a degree or volume by Landlord, during the Base Period, shall be included in Lease Year operating expense only to the extent of an amount equal to the increase in the cost thereof over the actual or deemed cost figure which would have been includible therefor in Base Period operating expense had the expense thereof been incurred to the same extent and in the same degree or volume during the Base Period."

From the foregoing it is evident that a landlord would be required to maintain more detailed accounting records than customary of wage rates and hours of work performed by employees, unit costs and quantities consumed of supplies and materials, units of consumption of utilities with related rates, and other voluminous statistical material in order that proper comparisons of Lease Year costs may be made with the Base Period.

Under this type of lease, therefore, a landlord instead of being able to fully escalate his increased costs, is confined to only those increases which in the final analysis pertain only to the increased rates from year to year. This conforms theoretically with the intent of both the landlord and tenant who, when writing this lease, had in mind to provide only for increased rates for labor and materials, outside maintenance services, etc.; above and beyond a "normal" base period. The rental charge by the landlord per square foot of rented area in effect considered such base or normal period for operating expense in the determination of his net profit. The aforementioned escalation clause, therefore,

protects the landlord's net return provided he maintains a "normal" type of building operation throughout the term of the lease.

However, good intentions notwithstanding, a building manager will find considerable difficulty in conforming to the rigid specifications of this formula. He will be required to work his personnel in total number of hours to the same extent as in the Base Period; he will purchase the same number of mops, brooms, nuts and bolts, etc., as in the Base Period; he will turn off valves, pumps and motors at precisely that moment which will enable him not to exceed the consumption of steam, water and electricity in the Base Period; in short he will maintain a static or regular operation throughout the term of the leases so that his costs will not increase from year to year, except for price and rate fluctuations.

As ridiculous as this appears, it nevertheless conforms to the aforementioned principles as defined in the lease document. A landlord or his building management will therefore be unable to operate in any manner, intentionally or otherwise, that would deviate from the Base Period, since he would not be able to recover in escalation increased costs beyond the scope defined, nor create efficiencies without in effect turning over to tenants the amounts which may be saved in operating costs. If increased costs were necessary to create these efficiencies, he not only would be unable to recover these costs, but would be giving his tenants the benefits in the resultant reductions in operating costs.

If break-downs of operating facilities occurred, resulting in costly repairs, he would only be permitted to recover in escalation the proportion of cost measured by the increased rate over the rate which would have existed during the Base Period had such expense been incurred during that Period. A similar situation would apply in the case of emergencies or unforeseen circumstances such as providing increased security personnel during a period of riot. The increased hours of labor would not be fully included in billings for escalation.

REQUIRED ACCOUNTING RECORDS

Management relies upon its accounting staff for full information necessary to enable it to budget expenditures within the framework of its basic period, thereby insuring its expected return on the capital invested. The following supplementary procedures may offer some solution to this perplexing accounting problem: It is recommended that the accounting system be designed to furnish cumulative information, on a monthly basis, of the costs of various kinds of building operating expenses so that current comparisons may be made, from time to time during the lease years, with expenses incurred in the base year. These comparisons should be departmentalized for better control of fluctuations which are likely to occur.

In addition, compilation of certain statistical information, beyond that which would ordinarily be prepared by the accounting group, is necessary if the landlord wishes to collect from its tenants the full amounts of escalation due. The following auxiliary records are suggested:

(1) *Salaries and Wages:*

A schedule of salary rates of accounting, office and clerical employees, together with operating department heads and assistants, in each job category, should be prepared for the base year, on a weighted average basis, if pertinent, and for each lease year thereafter. The dates of every rate change should be noted for each job. Escalation is computed by multi-

plying the difference between base and lease year rates by the total number of applicable weeks worked in the lease year.

A similar schedule of wage rates, together with hours worked, should be prepared for the labor group on the basis previously described for the base and lease years. This should be departmentalized for each rate category for example:

(a) Janitorial Department—
Porters, Cleaners, Matrons, Waxers and Others

(b) Mechanical Departments—
Plumbers, Carpenters, Electricians, Mechanics, Apprentices

Escalation is computed by multiplying the rate changes in each labor category by the number of hours worked during the lease year.

(2) *Other Compensation:*

Employee Benefits, considered as part of a negotiated union wage "package", should be scheduled so as to properly support the increased costs resulting therefrom. The following types of such benefits are includible in escalation:

(a) Vacations—The amounts paid to employees in the lease years, in excess of amounts paid in the base period are in effect a wage increase.

(b) Lost-Time Benefits — These would include hours paid for sickness, holidays, birthdays, pregnancy leave and the like during the lease years in excess of amounts paid during the base year, due to labor negotiations in effect during such lease year, but not in effect (or to as great an extent) in the base year.

(c) Pensions—The increased cost of pension-plan contributions during the lease year are also in effect a wage increase.

(d) Cost of Providing Increased Benefits — When, during a lease year, temporary employees are required to fill-in for vacations and other hourly benefits to a greater extent than in the base year, such additional hours, at base year wage rates, are includible as escalation.

(3) *Payroll Taxes:*

The taxable payroll for the lease year is the basis upon which F.I.C.A. and Unemployment Insurance tax rate increases may be applied for computing escalation. It is important, however, to keep additional payroll records to support the amount of increases in these taxes which are attributable to salary and wage rate adjustments. These adjustments will increase the taxable payroll in lease years to the maximum limits (upon which the taxes are computed) beyond that existing in the base year.

(4) *Maintenance Supplies and Expenses:*

This category of operating expense may be sub-classified under many captions but the overall treatment is similar. Record keeping should be augmented to provide for price changes of supplies and services so that a trend from year to year may be determined as the basis for computing rent escalation. U. S. Department of Labor Price Index Bulletins are helpful in comparing these price changes and other media may be so employed.

If, in lieu of a comparison of "each single item or thing", the tenant would agree to the acceptance of a percentage of increase in the lease year as related to the base year (and this appears to be a reasonable approach),

then a simple computation to determine the base year cost of a group of similar items is made. The difference between the lease year cost and the actual or deemed base year cost is the amount includible in escalation.

(5) *Utilities—Electricity and Steam:*

Since more than one rate is involved in the computation of amounts includible in rent escalation for utilities, separate treatment for each type of charge is found to be workable. For both base and lease years, the combined Base Service Rate and Fuel Adjustment Rate charged by the utility Company, in the respective consumption brackets, is determined on a monthly basis. This is necessary because of the frequent changes in the Fuel Adjustment Rate. The increase (or decrease) in rates for each month of the lease year as compared with the corresponding month of the base year are applied to the related lease year consumption to determine the monthly increases (or decreases) attributable to such rate changes. The total of these increases, net of decreases, represents the amount includible as escalation.

Demand charges in respect to electricity are based upon monthly peak demand for power and similar treatment as described above would apply in the event that demand rates were changed in any lease year.

(6) *Other Expenses:*

For such other items of expense not specifically commented upon above, the same principle would apply, namely; the rate changes in the lease year as compared with the base period, multiplied by the lease year quantities or units of measure, determines the amount includible in escalation.

FINANCING AND TAX PROBLEMS

It may be asked why a landlord should be so privileged as to consider charging his tenants with increased costs over which the tenants have no direct control. Since long-term leases are an integral part of present day mortgage financing they, in effect, make both landlord and tenant quasi-partners in a venture so large as today's modern office building. Under the constant payment plan for interest and amortization of mortgages over a protracted period, an income tax problem sometimes develops after a certain number of years. As the amounts of mortgage amortization increase and the interest charges decrease, the taxable deductions likewise decrease to the point where depreciation charges are less than amortization payments, creating taxable income in excess of net cash remaining after all disbursements. If a landlord is unable to maintain a fixed return from rentals with a fairly constant net cash flow to meet his financing obligations and income tax payments, he will soon sink into financial oblivion. With present increasing interest rates and the current tight-money market, it is becoming more difficult for a landlord to refinance his mortgage obligations.

It is therefore the responsibility of the accounting profession to assist its landlord clients in resolving these problems involving interpretation of escalation clauses in leases and to prepare for study long-range projections of cash income and expenditures. If it could possibly be arranged, the independent public accountants of both landlord and tenant should be invited to sit-in on leasing negotiations, prior to the signing ceremony, and assist in arriving at an understanding of the terms and conditions of the documents. A closer cooperation with attorneys during lease negotiations would be most helpful in possibly avoiding and minimizing these problems.

New York Tax Administration in the "Space Age"

By HON. JOSEPH H. MURPHY

AT the National Tax Association's 53rd annual conference in New York recently, tax experts from government, industry, the universities and the legal and accounting professions met to dig deep into the problems of tax administration and tax enforcement in this new "Space Age".

Those of us who took part in those meetings were trying to find solutions to problems raised by growing population . . . by the changing revenue demands to finance public services at all levels of government . . . and by no means least of all, the increasingly complex job of more efficient administration and enforcement of our tax laws.

If our present prosperity fulfills expectations, the job of tax administration is bound to increase in complexity. Consequently, we would be faced with staggering administrative costs if we adhered to horse-and-buggy techniques.

The answer, of course, lies in the utilization of electronic computing equipment to meet the problems of tax administration just as it is meeting the problems of the space age and the satellite.

To do the job with which we tax administrators are confronted, the use of manual processes would require more personnel and more office space than any governmental unit could hope for—or pay for. Therefore, we must resort to the most modern scientific techniques if we are to achieve our objectives of efficient and economical administration.

In our continuing efforts to improve, modernize and streamline the operations of the New York State Tax Department, we are already making use of electronic equipment very much like that which is being used in our conquest of space.

With the help of these modern marvels of electronics, we have been able to make State income tax refunds totalling $97 million to 3.2 million taxpayers—and do it on schedule.

These same electronic machines next year will enable us to offer a new and convenient service to many taxpayers who use the new State Short Form, IT-200. When they file their returns, these taxpayers will provide us with figures from their Federal income tax returns. With that information, and a few blanks filled in on the State Short Forms, we will be able to compute their State tax for them, then send them either a bill for the tax due or

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a refund check, whichever the case may be.

SELECTION OF RETURNS FOR AUDIT

Already, we are making use of this kind of equipment to help select returns for audit.

I'd like to describe for you how this is being done and why it would be impossible for us to keep abreast of the increasingly heavy burden of auditing tax returns without this kind of high-speed and nearly automatic assistance.

I am sure all of you recognize the fundamental importance of a sound audit program to insure that each person should be asked to pay neither more nor less than his rightful share of the cost of government.

At first, it might appear that the safest way to make sure all taxpayers accurately report their taxes is to check each return carefully and follow up on any item which suggests further investigation. However, this approach is both impossible and impractical since most taxpayers are thoroughly honest and since many cases arise where the cost of conducting the audit exceeds the expected return.

Our previous audit system was essentially extensive in nature with virtually no selectivity. Since most taxpayers are fully aware of their tax responsibilities, locating those returns which required audit was extremely difficult. The result was an exceptionally small yield per return examined.

Furthermore, the growth in number of returns filed has been significant for each year in the postwar period. As a result, the audit program was faced with enormous and increasing backlogs. Furthermore, there was some evidence that the audits tended to become superficial because less time was available for doing the job properly.

This growing lag in the assignment of returns to the audit process had become so serious that we were dangerously close to the three-year statute of limitations. In previous years, this problem was solved simply by adding more auditors. That route can be followed only so far and then it becomes costly, unwieldy and entirely impractical.

We had to develop a more realistic basis of selecting cases for audit. Our Research Bureau felt that this objective could be attained through the use of measurements reflecting inherent marital and income differences among taxpayers.

Research surveys of tax returns used data on sources of income—wages, interest and dividends, business or professional income, rents and royalties. This information was classified according to tax payments, both normal and capital gains, residence and marital status of the taxpayer. Analysis of this information revealed a steadily rising ratio of deductions claimed to gross income reported. It was decided to make a qualitative evaluation of deductions in the light of established "normal" behavior.

The use of "norms" was to be the pivot around which the entire audit selection procedure would revolve.

What is a "norm"? If John Smith earned $5,000 last year and gave $50 to charity, we would certainly not accuse him of an excessive deduction. But, if he claimed an allowance of $500, we would conclude either that he was unusually charitable or that he was minimizing his tax liability.

Obviously, our "norm" for contributions is neither $50 nor $500 but some reasonable level between them. What we looked for was that point which a person in a given marital status with a given income would not likely exceed.

With the information the Bureau had been collecting for more than 12 years, it was in an advantageous position to develop adequate norms to reflect the changes in taxpayer deduction patterns for different income levels and marital status.

Such items as contributions, mortgage interest and real estate taxes tend to correlate fairly closely with income level and are definitely affected by the marital status of the taxpayer.

So sensitively attuned are these deduction patterns that significant differences can be found even between married taxpayers filing joint returns and married persons filing separately.

The best norms in the world would not help us very much if the Department was not able to handle the volume of returns selected by the process.

We needed a vehicle by which the theoretical concept of norms could be translated into a practical tool.

A manual approach to the determination of audit cases was impractical, since it would entail the impossible job of comparing each appropriate deduction or income item on each return with the established norms.

Conventional machine accounting equipment would relieve audit personnel of this burden but would introduce many other problems.

Our investigations indicated that the solution to our problem called for use of an electronic computer. I'm no expert on this subject myself and it is sufficient to note that the computer contains a memory unit which provides for the simultaneous storage of many pieces of information and for the application of many test conditions.

With the computer, we are able to analyze each tax return, determine whether or not it should be audited and, for those cases requiring audit, prepare punched cards which serve to identify the item or items needing scrutiny.

I should like to point out that the cost of installing these electronic computers and paying the monthly rental fees are such that we would not have considered them if we did not have other mass processing jobs to justify this expenditure.

OTHER MACHINE FUNCTIONS

Selection of returns for audit requires only about 6% of the available computer time. The rest of the capacity is allocated to research projects and to the tremendous volume of calculations resulting from the application of the withholding feature of the income tax law.

In processing tax returns filed under the withholding tax program, in addition to routine selection for audit, the computers:

1. Check the accuracy of the tax payer's arithmetic.
2. Compute the amount of any refund, credit or payment due.
3. Select returns requiring immediate audit prior to refund.
4. Provide
   a. Refund Checks and Schedule Listings
   b. Credit documents
   c. Notices of arithmetical errors
   d. Bills for any balance due
   e. Alphabetic Index to the Numeric return file.

In addition, the computers service the employer accounts and are being used in special projects such as comparison of employer withholding records with tax return data.

They will be of invaluable help to us when we begin to match 1957 tax returns against 1959 tax returns to narrow the gap between current tax collections and past tax obligations.

IMPROVEMENT OF STATE TAX STRUCTURE

Along with the streamlining of the State Tax Department's method of

auditing returns and its use of modern electronic equipment to speed up the work of a growing load of tax administration problems, we have not lost sight of the continuing job we have to do in constantly scrutinizing areas where improvements can be made in our State tax structure and its impact on all of the citizens of the State.

That, too, is part of the program of modernization and streamlining which we have undertaken.

One of those areas—affecting the great bulk of our New York taxpayers —was in the matter of simplified tax returns. The New York State taxpayer had to file a State and a Federal return and thus had two different sets of figures to contend with in computing his State and Federal returns, with the double trouble and in some cases, the double cost of having these tax returns prepared.

As long ago as 1958, I served on a committee of the State Bar Association which was formed to study this problem of tax simplification and to see what could be done to help the State move more swiftly toward conformity with the Federal income tax filing procedure.

The broad outlines of the tax conformity proposal were first advanced in the Legislature through studies by its fiscal committees.

Under the sponsorship of Senator Henry A. Wise of Watertown and Assemblyman William S. Calli of Utica, a constitutional amendment permitting conformity with the Federal law was brought before the Legislature. As you know, the voters last November overwhelmingly endorsed Amendment No. 8, and Governor Rockefeller signed into law the necessary implementing legislation.

In brief, this act will mean that the State taxpayer can make use of new and very much simplified State income tax forms. He will no longer have to make a number of separate computations of income and deductions but in most cases will be able to use the figures shown on his Federal returns.

For the taxpayer who prefers to use the "short-form" he will find the new short form probably will be kept to a single card with instructions on one side and only a minimum number of information blanks to fill on the other.

For the taxpayer who prefers to itemize his deductions—rather than take the flat 10 percent as with the short form—his job will be much easier for in most cases he will be able to carry over the figures from his Federal return without change to his State return.

Farmers, professional men, small businessmen in particular, will benefit in several ways, thanks to the modernized and simplified tax law.

Farmers and small businessmen as well as professional people will, for instance, be allowed to take the standard New York deductions and still deduct all expenses of business operations.

There are an estimated 350,000 mutual fund shareholders in New York State. For the first time, distribution of capital gains realized by mutual funds will be taxed as capital gains rather than regular income. In addition, the first $50 of dividends received by a taxpayer in each year will be excluded from New York income.

The law makes no change in ordinary income tax rates, tax credits or personal exemptions, nor does it adopt any of the Federal tax credits.

Another area in which modernization and some measure of relief has been effected is the area of business taxation. I'm referring especially to the Unincorporated Business Tax and the Highway Use or Truck Mileage Tax.

In the case of the former, the Administration has felt that additional relief should be accorded the proprietors of an estimated 85,000 unincorporated businesses in New York State.

An amendment to the present Unincorporated Business tax effectively eliminates the tax for almost half the total, and mitigates the effect of the tax for about half of the remainder.

These benefits will be accomplished in this way: If the taxpayer's unincorporated income tax liability is computed at $100 or less, a credit will be allowed for the entire amount of the tax. If the tax is more than $100 but less than $200, a credit shall be allowed in the amount by which the tax is less than $200.

For the convenience of truck operators in New York State, an optional method of paying the Truck Mileage tax has been provided for next year.

The present law calls for the computation of the tax on the basis of gross weight and applies to each truck unit operating on the State's highways. In order to relieve the burden of compliance with this law, the new optional method allows truckers to pay their tax on the empty weight of the power unit. This will greatly facilitate bookkeeping and the maintenance of records for the carrier.

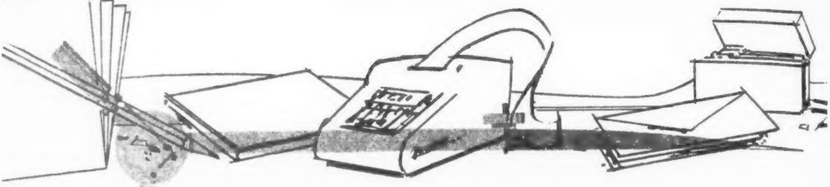
Further relief in complying with this law has been provided for small operators with an annual tax of less than $200. These carriers may file an estimate of the year's tax at the beginning of the year and file one tax return at the end of the year instead of a separate return for each quarter.

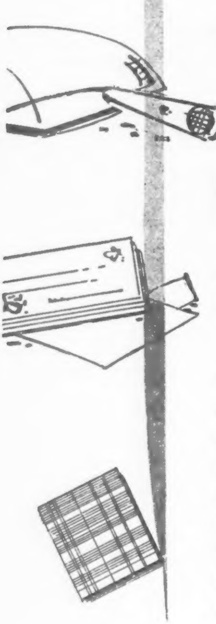
Many of the forward steps we have taken to modernize the State's tax laws during this administration have been made possible through the work done by several tax study groups. The Governor's Tax Structure Study Committee served as the focal clearing house for the overall survey of the State's taxes.

Similar study groups have been set up within the Tax Department to assist in pinpointing its investigation into ways of making still further improvements in our tax program.

The benefits we have achieved so far —implementing the withholding program—the *Wise-Calli* Bill and its accompanying benefits through conformity and simplification . . . the tax relief now provided some segments of our business community—all of these and still others to come have been made possible by the efforts of groups of experts who have given their knowledge and professional skills to the problems.

It is our intention to continue some of these study groups in force. We have made several significant forward steps toward bringing the New York State tax program up to date. Modernization is still needed in many areas, and that must be our objective if we are to keep the vital operations of our revenue-raising agencies abreast of the times in this fast-moving "Space Age".





New York State Tax Forum

Conducted by PETER ELDER, CPA

On October 26, 1960, the Society's Committee on New York State Taxation sponsored a technical meeting at the Statler Hilton Hotel. Commissioner Joseph H. Murphy was scheduled to address the audience on the subject of "New York State Practice and Procedure." While the Commissioner was unable to be present because of illness, we did have the good fortune of having Mr. Edward Rook, legal assistant to the Commissioner, address our audience on this very important subject.

In addition, there was a panel discussion, moderated by Mr. Philmore H. Friedman, during which many interesting ideas were developed. Through an effective use of questions and answers, clarification was obtained on many points concerning New York taxes. For the benefit of those members who were unable to attend the meeting, we shall present some of those ideas.

FILING RETURNS UNDER THE NEW LAW

Mr. William H. Shron indicated that as a result of conformity between the New York and Federal personal income tax laws, the mechanics of filing a New York State personal income tax return will be greatly simplified. For most taxpayers, all that will be involved will be copying a few figures from the Federal return. The taxpayer will carry over the total Federal adjusted gross income, the total of his itemized deductions, and the number of his exemptions. However, there might be some required adjustments to the Federal adjusted gross income, and to the itemized deductions; also, New York State will require some itemization of the details of the Federal figures. In lieu of such detail, the taxpayer may file a copy of his Federal return.

It was then indicated that where a joint Federal return is filed it will still be necessary to file separate New York returns in order to take advantage of the graduated tax rates. However, concerning this area, New York has made substantial improvements. Since the filing of separate returns will be on one multi-column form, this form will be called the New York State Combined Tax Return—Form IT-208. Furthermore, the deductions from adjusted gross income may be divided between the husband and wife in any way they choose. It should be noted, however, that adjusted gross income and exemptions will have to be divided between husband and wife as if they had filed separate Federal returns. On the reverse side of the form some detail will have to be given as to how the income shown on the Federal return is allocated to the husband and wife.

PETER ELDER, CPA, is chairman of our Society's Committee on New York State Taxation. Mr. Elder is a member of the firm of Peat, Marwick, Mitchell & Co.

VARIANCES FROM FEDERAL LAW

Although New York has adopted the concept of conformity with the Federal income tax, Mr. Shron advised the group that New York has not adopted the various Federal credits to tax. In other words, conformity ends at the line of taxable income. Thus, New York will not allow the 4% dividend credit although the $50 dividend exclusion is allowed; neither will the foreign tax credit, the retirement income credit, nor the reduced rates for heads of household be permitted. However, New York has continued the credits from the prior year of $10, $12.50 and $25.00. Furthermore, a surviving spouse will be entitled to $25 credit. It may be noted that the definition of "surviving spouse" as well as "head of household" will be the Federal definition.

It was further indicated that New York will no longer tax capital gains separately, and that it does not have an alternative tax computation. Capital gains will be included in the taxation of income under the same rules as for Federal purposes; short-term capital gains will be taxable in full, and long-term gains will be taxable to the extent of 50%. In connection with this point, it should be noted that the only allowable capital loss carryover will be that which appears on the Federal return, which means that for New York purposes taxpayers will now be permitted to deduct $1,000 of a net capital loss against ordinary income, plus, of course, $1,000 of net capital loss for each of the five carryover years. In connection with this point, it was indicated that if a husband has a $5,000 net capital gain, and a wife has a $5,000 net capital loss, these items would offset each other on the Federal return. If the taxpayers file separate New York returns, the husband will report a $5,000 net capital gain while the wife will be permitted to deduct a net capital loss of $1,000, which means the wife will lose a $4,000 capital loss deduction since the New York return for the following year will once again start with the figures found on the Federal return.

The question of net operating loss carryovers and carrybacks was discussed with the panelist indicating that any loss carryover on the taxpayer's 1960 Federal return will automatically be reflected on his New York return. This means that losses as far back as 1955 will be deductible for New York State purposes. However, any losses that are carried back to any year prior to 1960, and are absorbed for Federal tax purposes, would appear not to be available as carryovers for New York purposes even though no benefit is derived for New York purposes.

The panelist advised that at least half the adjustments, or modifications in connection with converting Federal adjusted gross income and Federal itemized deductions to comparable New York figures concern themselves with the fact that New York will continue to exclude interest income on U. S. obligations, and to deny interest deductions in connection with income not taxable for New York purposes. Also, all income taxes deducted for Federal purposes must be added back, which means that the New York State income tax continues to be nondeductible. Likewise, a refund of New York State income tax may be excluded from New York adjusted gross income. New York will continue to allow the $150 life insurance premium deduction. The two most important modifications are those which reduce Federal adjusted gross income. One concerns itself with property disposed of, where such property had

a higher basis for New York purposes than for Federal purposes at the date of the changeover to the new law, and the other concerns itself with not taxing income which had been previously taxed by the State. An example of the first type of adjustment is as follows:

Assume that because of lower depreciation deductions under Article 16 (the old New York Law) than the depreciation allowed for Federal tax purposes, taxpayer's adjusted basis for property is $90,000 for New York and $80,000 for Federal purposes on December 31, 1959. Taxpayer sells such property in 1960 for $90,000, which means there is a $10,000 gain for Federal purposes. However, since the basis for New York is $10,000 greater than for Federal, taxpayer may reduce the gain to the extent of this difference in basis, which means there will be no gain or loss for New York purposes. It should be noted that a gain for Federal purposes cannot be converted to a loss for State purposes. The gain may only be reduced to zero.

REVISIONS IN UNINCORPORATED BUSINESS TAX

Mr. Irving Levin advised the group that Article 23, dealing with the unincorporated business tax law, also conforms New York Law with the Federal Law. It was indicated that the starting point for the unincorporated business tax is Federal gross income and Federal deductions to which certain adjustments must be made to arrive at the unincorporated business net income. The modifications applicable to the personal income tax law are, likewise, applicable in determining unincorporated business net income. The panelist indicated that proprietors' or partners' salaries, and the specific exemption are still permitted as deductions for the purpose of computing the unincorporated business tax. It was further indicated that while the unincorporated business tax law closely resembles the personal income tax law, there are areas of differences, such as, the tax treatment for a gain arising from the sale of business property. Thus, capital gain treatment under Federal and New York Law is not available under the unincorporated business tax law, and all gains are taxed in full. Therefore, there is no 50% deduction for net long-term capital gains. However, such losses are allowable in full without any limitation.

A comment was made concerning the conformity provisions with regard to the use of taxable years for Federal and State returns. It was stated that under the present law if a taxpayer changes his taxable year for Federal tax purposes he must also change it for the unincorporated business tax. In connection with this point, while there is no requirement to annualize income for a short taxable period, the specific exemption of $5,000 must be prorated. However, there is no requirement to prorate the allowance for personal services of a proprietor, or partners for a short period return.

Mr. Levin indicated that an individual could practice an exempt profession and also conduct a business subject to the unincorporated business tax, and if the two activities were combined and not properly segregated the income from both activities would be subject to the unincorporated business tax. Support for this position is found in the regulations which indicate that a pharmacist is subject to all income from his store, including

the sale of prescriptions, unless a proper segregation is made for prescription income and its applicable costs, from other items of income and expense.

REVISIONS IN TAXATION OF ESTATES AND TRUSTS

Another panelist, Mr. Murray L. Brinn, advised the group that Article 22 of the New York State Tax Law also applies to the taxation of resident and nonresident estates and trusts. In connection with this matter, it appears that the sole test for determining resident or nonresident status of estates and trusts is that of domicile of the creator. It was indicated that it was unlikely that a residence of a fiduciary entity could be changed. In reply to the question of how the taxable income of resident estates and trusts is determined, it was indicated that, as in the case of individuals, the New York taxable income of a fiduciary commences with the Federal taxable income. For this purpose the deduction for distributions determined under Federal law is not changed. Three modifications are provided in order to arrive at New York taxable income, namely, the personal exemption of $600 irrespective of whether the entity is an estate or a simple or complex trust; an adjustment to reduce gains reported on the Federal return for excess New York basis of property sold, but only where such gains are taxable to the fiduciary for Federal purposes; and an increase or decrease in the Federal taxable income to the extent of the estate or trust's share of the New York fiduciary adjustment. An example of the fiduciary adjustment is as follows:

> Assume a trust received $1,000 of interest income on New Jersey bonds, $250 U. S. bond interest, and had paid $150 of New York State income tax. The $1,000 was not included in Federal income but is taxable to New York. Therefore, this is a plus adjustment. The $250 item was taxable for Federal purposes but is not taxable for New York purposes. This is a minus adjustment. The $150 for New York State income tax was deductible for Federal but is not deductible for New York. This is a plus adjustment. The net of these adjustments is a plus adjustment of $900 which is the amount of the fiduciary adjustment. As a general rule the allocation is in proportion to shares of Federal distributable net income.

It was observed that in the case of a simple trust it would not appear that any part of a fiduciary adjustment would ever be allocated to the entity even though the entity might have New York taxable income and be required to pay a tax thereon. This situation can arise where capital gains are allocated to corpus under the terms of the trust instrument since in such instances such gains would be excluded from the definition of distributable net income.

In connection with net operating loss carryovers, capital loss carryovers and deductions in excess of income in the year of termination of an estate or trust, it was indicated that since the Federal figures are used as a starting point for New York State purposes, such items will automatically be reflected in the New York taxable income of the persons succeeding to the property of the estate or trust.

In the discussion concerning nonresident trusts and estates, and nonresident beneficiaries, Mr. Brinn advised the group that it would be necessary to classify the items of income, gain, and deductions which form the Federal distributable net income ac-

cording to source, that is, New York sources, or other than New York sources. The determination of source is the same as that used in the case of nonresident individuals. This procedure must also be followed for resident entities with nonresident beneficiaries. The non-New York items are discarded. The next step is to make additions or subtractions to the New York items which form part of the distributable net income. These modifications are similar to those made to the income of resident individuals. For example, if a nonresident entity conducting a business in New York State has as part of the business assets U. S. bonds, the interest on these bonds would be subtracted. It was noted that for resident entities the starting point is Federal taxable income, while for nonresidents the items connected with New York sources are extracted from distributable net income. The allocation of New York items as modified is then made to the entity and the beneficiaries in proportion to their shares of Federal distributable net income.

ALLOCATION PROBLEMS OF CORPORATIONS

Mr. Mario P. Borini, in discussing the allocation problems of a corporation taxed under Article 9A, emphasized the fact that in order to allocate income within and without New York the taxpayer must show the existence of at least a regular place of business. The panelist indicated that a regular place of business is any bona fide office, factory, warehouse, or other space which is regularly used by the taxpayer in carrying on its business. The existence of a regular place of business would enable a taxpayer to allocate its property within and without the State in determining its business allocation.

It was noted that if the taxpayer has a permanent or a continuous place of business outside the State of New York, it would be entitled to use all three allocation factors, namely, property, receipts, and wages in determining its business allocation percentage. A permanent or continuing place of business is defined as any office, factory, or other space continuously occupied and used by the taxpayer in carrying on its business in its own name in a systematic manner through its regular employees in constant attendance. The question was then posed as to whether a taxpayer would be entitled to allocate its business income if it shipped goods on consignment to an out-of-state independent factor. Mr. Borini indicated that since the factor's place of business would not constitute a regular, permanent or continuous place of business of the taxpayer, no allocation would be permitted.

The group was advised that where a corporation subleases part of the premises which it rents in New York, assuming that the taxpayer corporation is entitled to use the business allocation factor, it would be necessary for the corporation to offset the rental income it receives against the rent paid for the premises in determining the value of its rental property. A further comment on determining the value of rental property was to the effect that if a taxpayer's lease requires the taxpayer to pay any increase in real estate tax in addition to an annual amount of rent, such additional payment must be considered in determining the value of rental property.

The moderator inquired as to whether a corporation would be entitled to an allocation on the basis of the investment allocation percentage rather than the business allocation

percentage where such corporation owns Federal bonds on which it received interest during the taxable year. The panelist indicated that if the corporation owned no investment securities other than Federal bonds, such bonds would be considered part of business capital and interest therefrom would be considered business income. Consequently, the business allocation percentage would be applied and there would be no investment allocation percentage. However, if the corporation owned other investment securities in addition to Federal bonds, it could compute its investment allocation percentage in the usual manner, and this percentage would be applied to all investment capital and investment income which would include the Federal bonds and income therefrom. Therefore, it was suggested that if a corporation owns only Federal bonds it might be advisable for the corporation to acquire some other investment securities in order to allocate Federal bonds and income therefrom on the basis of investment allocation percentage. However, it should be noted that this would be advisable only if the investment allocation percentage would not exceed the business allocation percentage. A final comment on the investment allocation percentage was to the effect that it is not necessary for a corporation to have an out-of-state place of business in order to utilize such allocation.

The panelist indicated that under a recent amendment to the Franchise Tax Law, Treasury stock is no longer considered as investment capital, or business capital.

REAL ESTATE CORPORATION PROBLEMS

Mr. George Mandel, in discussing real estate corporations, reminded the group that the purchase of real estate located in New York by a manufacturing corporation located outside New York would not qualify such corporation as a real estate corporation even though its activities in New York State consisted solely of real estate operations since the activities of the business as a whole determines the taxable status for franchise tax purposes. In order to qualify, the real estate would have to be purchased by a subsidiary corporation, organized by the manufacturing corporation. As long as the parent corporation did not use a material part of the property, the subsidiary corporation would qualify under Section 182 as a real estate corporation.

In connection with a real estate corporation which owns an apartment house, the panelist indicated that if one apartment was rented as a furnished apartment, the corporation is subject to reclassification on the effective date of the rental of the furnished apartment since it would be construed that the corporation's activities did not consist solely of engaging in real estate activities. In connection with this matter, it was noted that while a corporation might be reclassified, it could, nevertheless, requalify as a real estate corporation assuming that the reasons for the reclassification had been eliminated. It is not necessary to obtain permission from the State Tax Commission in order to be requalified as a real estate corporation. Mr. Mandel advised that a tax liability arises when a real estate corporation is reclassified. Such liability is a 2 percent tax on surplus as of the date of the reclassification. He noted that surplus includes not only earned surplus, but also surplus arising from appreciated values of the real property. For example, if the book value of real estate is $150,000,

and its fair market value is $200,000, 2 percent tax will be due on the $50,000 appreciation, as well as on the earned surplus of the corporation.

The panelist commented on the fact that while under Federal income tax law stock dividends are not taxable to the shareholders, such dividends would be subject to the 2 percent tax under Section 182. The basis of this statement may be found in an opinion of the Attorney General to the Department of Taxation and Finance during 1955 wherein it was pointed out that the apparent reason for stock dividends being considered taxable for franchise tax purposes was that in his opinion (Attorney General) the legislature did not specifically adopt such a provision. In connection with this point, Mr. Mandel indicated that a transfer of earned surplus to the capital stock account, without issuing new stock, would not result in the 2 percent tax even though par value stock was converted to no par value stock.

Why Lose Good Men?

Why do we lose good men? I am considering principally the younger men. Some describe their own situations this way: "I'm just not getting anywhere." A variant of this is, "I just don't know whether I'm getting anywhere," or "the going is too slow."

Young men want to grow. It is hard to find an able young man who doesn't hope to become a boss, a bigger boss, or the big boss. There is nothing wrong with this. It is normal ambition, candidly expressed. When we recruit young men, we always say we are looking for those who are intelligent, who have superior educational records, who have demonstrated initiative, drive, and ambition. Isn't it curious that after we have found them we show surprise, at times annoyance, when they attempt to display the very qualities for which they were selected?

If the young man in the bank is not growing as fast as his capacity permits, if he is not doing all that he could be doing, is the bank getting its money's worth? Obviously not. I call this managerial growth—with inflation. Nor is the young man getting full value. From his point of view, it is also managerial growth—with inflation. Only when the bank makes full and productive use of his abilities and acquired knowledge and skills, can we have managerial growth—without inflation. We are familiar enough with the principle that rising wage rates without commensurate increase in productivity is inflationary. We seem not to appreciate the need to be concerned with productivity associated with managerial growth.

ROBERT N. HILKERT, "Managerial Growth,"
TRUSTS AND ESTATES, October 1960

Accounting and the SEC

Conducted by Louis H. Rappaport, CPA

GOING PUBLIC: SEC PROCESSING TIME

How long does it take for a registration statement filed with the SEC to become effective? This is a question your client may ask when he is considering a public offering of securities of his company. Most public offerings of securities must be preceded by a registration statement filed with the SEC under the Securities Act of 1933.

The rush to go public has been so tremendous that the time required by the SEC to process registration statements has grown steadily. It is obviously impossible these days for the staff of the SEC to review and process registration statements in the same time that it took a few years ago. Not only is the number of registration statements at an all-time high, but—what is more important—the number of filings by new registrants is also at an all-time high. The time required to review a registration of a company well known to the SEC staff is, as one would expect, much less than is the case of a company with which the staff is not familiar. One way to speed up the processing would be to increase the size of the staff, but the SEC has serious budget problems. And these problems do not receive the sympathetic consideration in Congress that they deserve.

The backlog of registrations in the hands of the SEC, which recently began to decline, has now started to rise again. At the time of this writing the number of filings under the Act is running ahead of the registrations which become effective or are withdrawn.

The element of time is always an important consideration to a company thinking of a public sale of securities and to the prospective underwriters. Especially in these days of rapidly shifting security markets, it is an even more important consideration.

The SEC has released information regarding the average time required by the agency to process registration statements filed with it. "Average" figures are meaningless, however, because there is a substantial difference in time requirements applicable to (1) a company filing for the first time and (2) a "retread", that is, a company that has been through the registration mill previously.

We have analyzed a representative group of registrations filed with the SEC in 1960 with a view to determining how much time was consumed in the registration process. In this study only underwritten offerings were considered, because these customarily are expedited as compared with an offering where an underwriter has not been

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chosen. The processing time was taken as the interval between the filing date and the effective date. The offering date was ignored because delays occurring between the effective date and the offering date can not ordinarily be charged to the SEC.

In the case of companies *filing for the first time,* the average time in the SEC was 64 days. The fastest time was 42 days, the slowest 93 days. In the case of "retreads", the average was 35 days. The best time was 18 days, the worst was 62 days.

It should be borne in mind that this was the time taken by the SEC. Before the registration statements were filed, much time was spent by company officials, their lawyers, accountants, and underwriters in getting the registration document in shape for filing.

If your client is considering a public offering of securities, his planning should take into account not only the time required to prepare a registration statement, but also how long it will take the SEC to process it.

The Impact of the Social Sciences on Business

We are today in a period when the development of theory within the social sciences will permit innovations which are at present inconceivable. Among these will be dramatic changes in the organization and management of economic enterprise. The capacities of the average human being for creativity, for growth, for collaboration, for productivity (in the full sense of the term) are far greater than we yet have recognized. If we don't destroy life on this planet before we discover how to make it possible for man to utilize his abilities to create a world in which he can live in peace, it is possible that the next half century will bring the most dramatic social changes in human history.

I believe that the industrial enterprise is a microcosm within which some of the most basic of these social changes will be invented and tested and refined. As Peter Drucker has pointed out, the modern, large, industrial enterprise is itself a social invention of great historical importance. Unfortunately, it is already obsolete. In its present form it is simply not an adequate means for meeting the future economic requirements of society. The fundamental difficulty is that we have not yet learned enough about organizing and managing the human resources of enterprise. Fortunately, an increasing number of managers recognize the inadequacy of present methods. In this recognition lies the hope of the future. Industrial management has again and again demonstrated an amazing ability to innovate once it is persuaded of the opportunity to do so.

Douglas McGregor, The Human Side of Enterprise,
McGraw-Hill Book Company, Inc., 1960, p. 244-245

Administration of A CPA Practice

Conducted by Herbert G. Whiting, CPA

This department first appeared in *The New York Certified Public Accountant* in December 1950. Its title was "Office and Staff Management," and its purpose was described "first, to act as a clearing house for questions and answers and, second, to publish brief notes on the diverse aspects of office management as gathered from contributors and other sources."

In January, 1957 the column name was changed to the one it now bears "because the scope of this column includes administration aspects other than routine office and staff management matters——."

Now in December, 1960, the column is undergoing its second change. The name remains the same, the content and format remains the same, but it will no longer flow from the facile pen of Max Block who has conducted it so ably since its inception. During the past ten years Mr. Block wrote with a deep understanding of the myriad problems which we encounter daily in the administration of our practices. We have not counted the numerous subjects he covered, but we estimate that they total about five hundred.

HERBERT G. WHITING, CPA (N. Y., N. J., Mo.), is Chairman of the Committee on Administration of Accountant's Practice of The New York State Society of Certified Public Accountants. He is a partner in the firm of Bacon, Taylor and Beairsto, CPAs.

ADMINISTRATION SHOULD BE PLANNED

We do not doubt that some CPAs may be born managers. However, effective administration of a practice is more likely to be the product of conscious effort. Practices may survive or even expand in volume without a plan; few, however, will reach their full potential without the establishment of clearly defined goals.

Some small and medium sized firms operate from day to day without knowing where they are going or how they are going to get there. Decisions are made only moments before they are implemented; the results of past policies are seldom evaluated.

Such firms may succeed because a dominant partner has clearly thought out his long range objectives, which, although they have not been set down as firm policy, constitute in effect the policies of the firm. This appears to be a poor substitute for a plan so well thought-out that it can be summarized in writing.

Matthew P. Geraghty submitted the following thoughts on this subject:

"As a major step toward improving their organizational structure and management, accounting firms would profit considerably by developing a firm-wide set of objectives and operating policies.

"Such a program would require a clear definition of the firm's goals, a

delineation of the major policies that must be adopted to achieve such goals and a clear description of the duties and responsibilities of each individual in each management level.

"Some of the advantages to be derived from such a program would be:

1. Effective communication of the firm's policies and goals to every individual in the organization.
2. A clear understanding of each person's responsibilities both as to his superiors and subordinates.
3. An individual goal for every person in the organization.
4. A firm-wide concentration and direction of effort which would otherwise be difficult to obtain."

If you do not have a personal plan and a firm plan that is at least outlined on paper, the chances are you have not clearly defined your objectives and the mileposts you must pass in reaching them. Successful CPAs plan their futures; they do not rely on luck.

ACCOUNTING INTERNSHIPS

Luther B. Orr, Jr. writes:

A discussion of accounting internships at this time is timely because in December college students will be joining the staffs of public accounting firms to participate in internship programs. In most instances, this will be the college student's first experience in public accounting and his first contact with the profession. Every effort, therefore, should be made to give him an accurate picture of the firm and the profession, commensurate with the best possible experience.

A planned program should be adopted for each intern who joins your firm. Serious harm can be done to a firm's reputation at a college if interns are thrown at random into engagements without thought to the experience they might be getting. Each intern's program should be planned so that he obtains experience in various industries and covers the wide range of duties that are the responsibility of junior accountants.

When an intern reports for work, he should be shown around the office and introduced to as many people, including partners, as possible. His program should be outlined to him so that he knows to what engagements he will be assigned, for whom he will be working, how long he will be on each engagement, and what he will be doing. Even though assignments may have to be changed or modified at a later date because of unexpected developments, they should still be outlined to him in advance so that the student knows that careful planning went into the program set up for him. Unassigned time should be kept to a minimum. Sitting around the office doing nothing quickly discourages an intern because he feels that he is wasting time which could be better spent at school. If an intern has any free time, he should be allowed to browse through selected working papers and reports and to discuss any questions he may have regarding them with members of the firm's management group.

Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

SOCIAL SECURITY AMENDMENTS OF 1960

The Social Security Act Amendments of 1960 enacted by Public Law 86-778 are of considerable interest to all persons covered by the act, and to accountants in particular. In many instances new eligibility requirements are provided, effective January 1, 1961. Here is a brief report of the changes about which questions will be asked of accountants by clients and others.

1. *Earnings Limitation.* Under the old law, a beneficiary under age 72 loses a month's benefit for each $80 or fraction thereof by which his annual earnings exceed $1,200. Beginning January 1961, a beneficiary under age 72 who earns $1,200 or less will get his benefit payments for all 12 months of the year as heretofore. However, if he earns between $1,200 and $1,500, one dollar in benefits will be withheld for each two dollars of earnings above $1,200. If he earns more than $1,500, then one dollar in benefits will be withheld for each two dollars of earnings between $1,200 and $1,500 and one additional dollar for each one dollar in earnings above $1,500. There is no change in the rule that, regardless of how much a beneficiary earns in a year, he will get a benefit check for any month in which he neither earns more than $100 in wages nor renders substantial services in self-employment. There is no change in the rule that beneficiaries 72 years of age or older may receive social security benefits regardless of the amount other earnings or the extent of engagement in self-employment. It is also important to bear in mind that under administrative procedures adopted by the Social Security Administration, there may be a withholding of benefit payments if they doubt the right of the claimant to receive benefits despite his assertions of entitlement to the same. Should such a situation arise, and benefit payments are withheld, the claimant may demand a hearing before a referee.

2. *Service of Parent for Son or Daughter.* The 1960 amendments also cover services (for other than domestic service or casual labor) performed by an individual in the employ of his son or daughter after 1960. It will become necessary to include the earnings of the parent in the Federal Insurance Contributions Quarterly report, and to pay the social security taxes on the newly taxable wages. The new provision regarding wages paid to a parent will conform the Federal reporting liability with that of the New York State

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Unemployment Insurance Law. Parents who work for their children in a trade or business and who do not already have social security cards will have to apply for account numbers promptly.

3. *Members of the Clergy.* The new amendments extend an additional opportunity to members of the clergy who have not yet elected coverage, to obtain coverage if they file certificates by April 15th, 1962.

4. *Non-Profit Organizations.* The amendments remove the requirement that two-thirds of the employees of a non-profit organization must consent before the organization can cover employees who want to be covered, and its future employees.

5. *U. S. Citizens Employed by Foreign Government Agencies.* United States citizens who work within the United States for foreign governments, their wholly owned instrumentalities, and international organizations, will be covered beginning with 1960 as though they were self-employed persons. In such cases, when the Federal income tax return for the year 1960 is filed, a self-employment tax return will also have to be filed and the tax due thereon remitted.

6. *Disabled Persons.* Disabled persons may qualify for social security benefits at any age. The age 50 qualification heretofore in effect has been removed. Until now a disabled person under age 50 could apply to have his wage record frozen but benefits were not payable until he reached age 50. Disabled persons under age 50 who have had their records frozen will be informed by the Social Security Administration about their right to collect benefits. If no such notice is received by the claimant, he should be directed to apply at his local Social Security Administration office to have his claim revived and paid. A person under age 50 who has been permanently disabled and failed to have his wage record frozen, should apply at the local Social Security Administration office to secure a determination as to his eligibility for benefits under the new enactment. Persons who have had social security coverage for at least twenty quarters out of the ten year period immediately preceding the date of disability, may be entitled to benefits.

7. *Insured Status Requirement.* Under the 1960 amendments, a person can qualify for social security benefits if he has worked in covered employment or self-employment for *one-third* of the calendar quarters after 1950, or after the year in which he attained age 21, if that is later, and before he retires or becomes disabled. Formerly he had to work in covered employment for *one-half* of the quarters in this period. However no one can obtain benefits with less than six quarters of coverage. The new provisions do not affect the insured status of persons who have qualified for benefits under one of the alternate rules, such as having acquired permanent coverage by reason of having had forty calendar quarters of covered employment after 1936. Survivors of persons who died after June 1954 and who were not eligible for benefits under the old law may now be eligible.

8. *Increase In Children's Benefits.* Under the prior law each child under age 18 received a monthly benefit of one-half the amount his parent would have received had the parent lived to retirement age and drawn benefits. An additional one-quarter of the total amount was divided among all the children. Now the monthly benefit will be 75 percent of the wage-earner's retirement benefit for each child. The family maximum benefit payment is $254 a month or 80 percent of the

wage-earner's average monthly wage, if less.

9. *Disabled Beneficiaries Who Are Working.* Disabled beneficiaries who go to work despite severe handicaps can continue to draw benefits for as much as 12 months after returning to work. Disabled beneficiaries who go back to work but who again become disabled within five years after their benefits have stopped, will not be required to have a further six month waiting period before their benefits can start again.

10. *Aged Dependent Widowers.* The aged, dependent widower of a woman wage-earner who died before September, 1950, may be eligible for benefits if she had worked under Social Security for at least six quarters.

11. *Other Changes.* Benefits are now payable to persons such as widows, disabled children, and surviving dependent parents of wage-earners who died between March 21, 1938 and January 1, 1940 and who had at least six quarters of coverage. Such dependents, who were previously ineligible for benefits, may now file for them with a local office of the Social Security Administration.

Procedures for coverage of state and local government employees have been simplified and provision made for the broadening of coverage.

While the public at large and the citizenry have been exposed to another amendment to the Social Security Act, during the recent presidential election campaign, that relating to a provision for certain medical care benefits, only a minor portion of the law is devoted to that subject. However it is expected that much more will be heard about this new area of the present Federal social insurance program which has not as yet been integrated into the Social Security payroll tax structure.

NEW YORK STATE MINIMUM WAGE LAW BECOMES EFFECTIVE

In accordance with the new Minimum Wage Act, enacted in 1960, minimum wage orders governing the industries previously covered have been revised, and employers not covered heretofore are now subject to this new statute which became effective October 1, 1960. The minimum wage standards provided by Article 19 of the New York State Labor Law are:

1. The basic minimum rate of $1.00 an hour;

2. A minimum of $37.50 for each work week of more than 30 hours but not more than 37½ hours, except when the employee is voluntarily absent;

3. $1.50 an hour after 40 hours in any week;

4. Call-in pay on any day must be paid to an employee who is requested or permitted by the employer to report for duty on any day, and shall be paid for at least four hours at the applicable minimum rate, except to an employee of an establishment open for less than four hours on any day; or to an employee who is a student who regularly attends a full-time school on days of required school attendance.

5. An employee shall be paid $1.00, in addition to the minimum wage, for any day in which there is a split shift or a spread of over ten hours between work periods or in which both situations occur. This does not apply to full-time students as above stated in "4".

6. Meals and lodging furnished by an employer to an employee are considered part of the minimum wage. They shall not be valued at more than 25¢ a meal, and, for lodging 40¢ per day but no more than $2.50 per week, in determining whether or not the

minimum wage provision is in compliance.

7. In the retail industry minimum wage order, tips or gratuities received by the employee are not counted as part of the minimum wage. Other provisions for the treatment of tips or gratuities as part of the minimum wage structure are set forth in the orders for the other industries, copies of which may be obtained from the New York State Labor Department.

8. Uniforms that employees are required to purchase and wear on the job, must be paid for by the employer not later than the next date for the regular payment of wages following the date a uniform is purchased. If the employee is required to maintain and launder the uniform, the employee must be paid each week at least $1.50 in addition to the regular wages earned in a work-week of over 30 hours a week; or if the employee works 30 hours or less a week, he is entitled to $1 in addition to his regular weekly wage for uniform laundering and maintenance.

9. Wages shall not be subject to deductions for spoilage or breakage, cash shortages or losses, fines or penalties for lateness, misconduct, and for quitting employment without giving the employer required notice.

10. The minimum wage shall not be reduced by expenses incurred by an employee in carrying out duties assigned by his employer.

11. Employers are required to preserve for not less than two years weekly payroll records showing for each employee:— the name and address, social security number, the number of hours worked daily and weekly, time of arrival and departure of split shift employees, gross wages, deductions from gross wages, allowances if any claimed as part of the minimum wage, and the net cash wage.

Recruiting Accounting Help

There is a good deal that we can do with regard to literature and contacts with people who are responsible for education, but every time you have an interview with these people who advise youth you come up against the same hard, concrete facts. If you are going to recruit people into this profession, if you are going to keep them in the profession, you have got to pay them in a way which bears some relationship with what they get elsewhere. I am told from time to time that this is difficult because you do not get the income. You cannot give your clients the service unless you have the staff; you cannot give that service unless you charge the fees, a nasty but realistic fact. You have got to charge proper fees.

S. John Pears, F.C.A., from an address to The Institute of Chartered Accountants, The Accountant, October 29, 1960

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

CLAIM OF RIGHT DOCTRINE V. ACCEPTED PRINCIPLES OF ACCOUNTING

In an extremely well-reasoned and significant opinion, the Eighth Circuit Court of Appeals has reversed the Tax Court in a decision which is of interest to every accountant. (*Mark E. Schlude et al* v. *Com.* CA-8, 10/19/60). In reviewing the decision of the Tax Court (NYCPA, December 1959, pp. 904-905), we stated that the application of the "claim of right" doctrine to the facts in this case was most alarming in its radical departure from accepted principles of accounting, and pointed out some of its implications.

To briefly restate the facts: The taxpayers were members of an accrual-basis partnership which conducted five dance studios under franchises from Arthur Murray, Inc. Contracts with the students required payment of a specified tuition for a designated number of dance lessons. The student would make a down payment and pay the balance in installments, sometimes giving a note. The contract provided that it was non-cancellable, and that no refunds would be made; but, as a matter of fact, during the three taxable years involved (1952 to 1954) cancellations were from 15 to 19 percent of sales. The partnership reported as gross income the pro rata amount of the contract price based on the number of lessons taught during the year, the balance being credited to a deferred income account. The Tax Court upheld the Commissioner's determination (32 TC 1271) that the partnership was required to accrue as income the entire contract price in the year in which the contract was entered into (whether or not notes were received), since the partnership had a right to receive a fixed and determinable amount.

The Court of Appeals denies the applicability of the "claim of right" doctrine to the instant case, reasoning that the cases decided under that doctrine dealt with "prepaid receipts", "earned income" and the deductibility of "anticipated expenses" in connec-

tion therewith, rather than the treatment of "partly earned" income.

Emphasizing that the basic question at issue was whether the method of accounting employed by the taxpayers reflected their true income, the Court held that it did. It compared the instant case with *Beacon Publishing Co.* v. *Com.* (CA-10, 1955, 218 F(2d) 697), *Bressner Radio Inc.* v. *Com.* (CA-2, 1959, 267 F(2d) 520) and *Bayshore Gardens Inc.* (CA-2, 1959, 267 F(2d) 55) and distinguished *Automobile Club of Michigan* v. *Com.* (S. Ct. 1957, 353 US 180) on the grounds that in the last case "the *particular method* of deferral employed was unsatisfactory." [sic.] In the instant case, reporting the income as the lessons were given, thus matching the corresponding expenses, is a true reflection of the accrual basis of accounting, and any other method would distort income.

This decision is not only gratifying but it now means that three Circuits are in agreement as to the proper method of reporting income when earned, and perhaps marks the end of the unwarranted extension of a doctrine that was originally promulgated on the basis of a certain set of facts in *North American Oil Consolidated* v. *Burnet S. Ct.* (1931, 286 US 417).

BAD DEBT RESERVE IS NOT DEDUCTIBLE BY GUARANTOR

The automobile dealers again claim the spotlight. In this case the situation is different from those previously reported in that the instant taxpayer sold its sales contracts to GMAC with recourse. The taxpayer had set up a "Reserve for Bad Debts" to cover future losses on such contracts, and had claimed as a deduction the annual provision credited to the reserve account.

The Tax Court denied the deduction. It pointed out that the taxpayer was only a guarantor of the notes and that there was no debt owed it, since it became a creditor only at the time it paid the debt on behalf of the debtor. Because Regulations, Section 1.166-1 (a) and (c) (which the Court found to be a reasonable interpretation of the law) provide that the deduction on account of bad debts is only allowable to a creditor, the taxpayer was not entitled to deduct a bad debt provision. Furthermore, the Court points out, even good accounting practice does not provide for the deduction from current year's income of a reserve for a contingent future liability; and even if it did, the reserve is not deductible for tax purposes. (*Wilkins Pontiac* 34 TC —— No. 108)

SALES OF RENTAL CARS PRODUCE ORDINARY INCOME

The Tax Court's decision in *Greene-Haldeman* (reviewed in NYCPA, June 1959, p. 457) has been upheld by the Ninth Circuit Court of Appeals. The taxpayer's business was both that of dealer and that of automobile rental. The question involved is whether the gain realized upon the sale of cars which were used in the rental part of the business is taxable as ordinary income or at capital gain rates. The Tax Court held that its rental cars were property held primarily for sale to customers and therefore not subject to capital gains rates as provided in Section 117(j), IRC 1939, (similar to Sec. 1231, IRC 1954).

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The Circuit Court upheld the Tax Court. It reasoned that "the term 'primarily' as it is used in the Sect. 117(j)(1)(B) exception to capital gain treatment of property used in the trade or business . . . [means] 'substantial' or 'essential' rather than 'principal' or 'chief'." Based upon such an interpretation of the word 'primarily', the Court found that active prosecution of sales of used cars, as well as their frequency and continuity, were determinative that they were excepted from capital gains treatment. (*Greene-Haldeman* v. *Com.* CA-9, 9/21/60)

CARASSO DECISION IS REISSUED

The *Carasso* decision (discussed in NYCPA October 1960 p. 716) which was withdrawn as 34 TC —— No. 65 has been reissued as 34 TC —— No. 119.

The decision is the same, i. e. that the expenses for transportation to Bermuda were deductible as medical expense, both for the taxpayer and for his wife, but that the room and board expenses in Bermuda were not deductible. In its new opinion, however, the Tax Court has examined and overruled a contention of the taxpayer that the Court's reliance on Committee Reports and legislative history in construing the 1954 Code was not permissible. The Court also added to its opinion the rather equivocal statement that follows:

> "To the extent that the Court in Robert M. Bilder, 33 TC 155, 158 failed to examine the foregoing legislative history, that decision is hereby disapproved."

In the case of *Bilder,* the wife's expenses were disallowed as not being necessary for Bilder's medical treatment, but *his* room and board in Florida as well as his transportation were allowed. *Bilder* is presently on appeal in the third circuit.

In the *Carasso* case, there are now two dissenting opinions, one of which states, inter alia, that the Tax Court should have deferred its decision until the Court of Appeals ruled on *Bilder.* The other dissenting opinion adds that a review of legislative history is only warranted where the courts need aid in determining what Congress "has said" as opposed to using such reference to fill in "a void in the law".

SUPPLEMENTAL UNEMPLOYMENT BENEFIT PAYMENTS

Payments made by an employer directly to a former employee under a supplemental unemployment benefits plan, where there is no trust but merely an account on the books, and where no employee has any interest in such benefits except to the extent he qualifies for them under the plan, are deductible as ordinary and necessary business expenses under Section 162 (a) in the year paid (for cash basis taxpayers) or in the year in which the liability to the particular qualifying employees becomes fixed (for accrual basis taxpayers).

The payments do not constitute wages for purposes of the Federal Unemployment Tax Act, the F.I.C.A. or income tax withholding.

The payments are includible in the gross income of the recipients. (Rev. Rul. 60-330, IRB 1960-43, 7).

PARTIAL LIQUIDATION VS DIVIDEND

In order to determine a policy for procedure, a corporation requested a ruling based upon the following facts:

It had pursued a successful business operation, but during several recent years a serious and possibly permanent decline had occurred in its industry and, concomitantly, in its own business. To contract, it sold a substantial

part of its accumulated inventory at large losses. The liquidation of inventories and the curtailment of activities were continued at least for the current year, and, if prospects failed to improve, a complete liquidation of the corporation was contemplated.

In the meantime, the corporation wishes to redeem a portion of its outstanding stock in exchange for a distribution of cash realized from sale of U. S. bonds and liquidation of inventories. However, since it has a large earned surplus, the corporation has requested a ruling as to whether the exchange would qualify as a partial liquidation or would be treated as a dividend.

The Commissioner has ruled that neither the sale of investments nor the sale of inventory in the ordinary course of business constitutes a genuine contraction of the business. Accordingly, the distribution would be taxable as a dividend to the extent of accumulated earnings and profits (Rev. Rul. 60-322, IRB 1960-41, 7).

COMMENTARY

APPLICATION OF FOREIGN TAX CREDIT FORMULA

In defining the limits for the credit to be allowed for foreign taxes paid, the Internal Revenue Code of 1939 provided that the credit may not exceed that portion of the taxpayer's tax computed before credits as the ratio of his net income from sources within the foreign country bears to his entire net income. In its decision in *Gordon Duke,* 34 T.C. ——, No. 79, (1960) the Tax Court concluded that under the old Code, the net income factors used for the ratio mean "net taxable income". (This requirement is explicitly set forth in Section 904(a) of the 1954 Code.) By so holding, the taxpayer was not able to expand the allowable ratio by the inclusion in the fraction of income earned in the foreign country but which was excluded from U. S. taxable income. In reaching this conclusion the Court said: "The historic purpose in extending a foreign tax credit was to mitigate the evils of double taxation. . . . The evils of double taxation do not exist, however, where the income taxed abroad is exempt from United States tax."

This statement of the Court could (but presumably does not) reach the following situation: Assume that a U. S. citizen residing abroad receives income from compensation earned abroad which is subject to foreign income tax but exempt from U. S. income tax. Assume also that he realizes a capital gain from the foreign country referred to above, and that this capital gain is not subject to foreign income tax but is subject to U. S. income tax. In determining the foreign tax credit, can the taxpayer in this example include in the limiting ratio the foreign capital gain (on which no foreign tax was paid) if the effect is to allow a credit for the foreign tax paid on the earned income which is not subject to U. S. tax?

It is clear that "the evils of double taxation" do not exist in this hypothetical case. Nevertheless, by reliance on *James H. Brace,* T.C. Memo. Op., Dkt 34310 (1952), which decision is being followed by the Commissioner (Rev. Ruling 54-15), this fortuitous

use of the foreign tax paid is feasible. As a result, the foreign tax paid on the foreign salary (exempt from the U. S. tax) will permit the reduction, if not the elimination, of the U. S. tax on the capital gain (which as was noted was not the subject of the foreign tax).

It will be interesting to watch the future developments in this area. Will the Commissioner use the language in the *Duke* decision to reappraise his agreement with the *Brace* case which produces the result outlined above, or will he perhaps seek legislation to change this somewhat anomalous situation?

EXCESS DEDUCTIONS AND LOSSES ON TERMINATION OF AN ESTATE OR TRUST

In the final year of an estate or trust, where the deductions exceed income, the beneficiaries succeeding to the property of the estate or trust may, on their individual income tax returns, claim such losses or excess deductions (Section 642(h)).

Distinction must be made between business and non-business income and deductions. Business expenses (including administrative expense allocable to business income) are offset against business income and likewise non-business expenses are offset against non-business income.

The net business loss is deemed to be an *operating* loss. The estate or trust must carry the loss back to the three prior years. Any unused loss carryover is then available to the principal (corpus) beneficiaries and can be taken into account in computing their adjusted gross income. The first taxable year of the beneficiaries to which the loss shall be carried over is the taxable year of the beneficiaries in which or with which the estate or trust terminates. The final taxable period of the estate or trust and the first taxable year of the beneficiaries to which a loss is carried over, each constitutes a taxable year for purposes of determining the number of years to which a loss may be carried over. Once the unused loss carryover is made available to the beneficiaries, the latter can only carry forward any remaining portion of the loss. There is no carryback of the unused operating loss by the beneficiaries.

A net capital loss incurred by the estate or trust in its year of termination is available to the beneficiaries under similar rules. In addition, the unused portion of both net operating losses and net capital losses sustained in years prior to termination can be carried over into the tax returns of the principal beneficiaries.

The excess of non-business deductions over non-business income is allowed to the beneficiaries only in the year in which the estate or trust terminates. There are no carryovers by the beneficiaries to subsequent years, as in the case of unused operating and capital losses. These excess deductions, as distinguished from unused net operating and capital losses, can be de-

ducted by the beneficiaries only in computing taxable income, not adjusted gross income.

Therefore, in the final year of an estate or trust, the deductions must be carefully analyzed to determine the maximum amount which can be deemed as business expenses. Furthermore, the termination of the estate or trust should be so timed as to fall in a year when the excess nonbusiness deductions can be fully utilized by the beneficiaries since they cannot carry forward such deductions beyond the year in which the estate or trust terminates.

PROFIT-SHARING PLANS—PROHIBITED TRANSACTIONS

Profit sharing plans run the hazard of unwittingly entering into a seemingly proper transaction which nevertheless may constitute a prohibited transaction under Section 503 (c). For example the question may be raised whether a prohibited transaction under Section 503(c) occurs under the following circumstances:

A sponsor company of a mutual fund establishes a profit-sharing plan for the benefit of its employees and the plan provides that the assets of the trust be invested in shares of the mutual fund.

The income of the employer company consists of commissions on the sale of shares of the fund and a fee for managing the investments of the fund. The Investment Company Act of 1940 requires that all shares of a mutual fund be sold at the public offering price. The company must therefore inevitably incur a profit from the sale of the shares to the trust, and it also obtains income from managing the investments of the trust through the management fee it collects from the mutual fund.

Section 503(c) has the effect of prohibiting certain transactions by an exempt profit-sharing trust which will unduly benefit the employer company at the expense of the trust. The exemption is lost if, among other things, the trust purchases securities from the employer for more than an adequate consideration, or if a substantial amount of income or corpus of the trust is diverted to the employer.

There seems to be no reason why Section 503(c) would have to be invoked in this case. It is unlikely that the income obtained by the employer company from the trust will ever amount to more than a small portion of its total income even though the trust may grow in size over a period of years, and no income will be received other than in the ordinary course of business of the employer. As far as the trust is concerned, it pays no more than it would if a comparable investment were obtained elsewhere. It would make little sense from the standpoint of the employer company and its employees who are engaged in the sale and management of investments if they would be compelled to go to a competitor for the investment of their own savings for the sole purpose of not giving an incidental benefit to the employer.

PROPER IDENTIFICATION OF SECURITIES IN WASH SALES

A simple and effective means of tax planning often neglected is the proper identification of securities sold. A recent problem emphasizes this factor in connection with the determination of whether the loss on securities sold came under the wash sales provisions (Section 1091).

On October 1, 1950, Mr. Ecks purchased 100 shares of Z Corp. stock for $1,000. Ten years later, on Octo-

ber 1, 1960, he acquired another 100 shares for $1,100.

Subsequent to the second purchase, the price of Z Corp. stock dropped sharply and on October 14, 1960, he sold the stock he had acquired two weeks previously for $600. Is the $500 loss sustained allowable for income tax purposes?

In determining the answer to this problem, it is necessary to review the definition of a wash sale. Such a sale occurs where substantially identical stock or securities are acquired by purchase or taxable exchange within 30 days before or after the sale. Any loss upon the sale is not immediately deductible for income tax purposes.

Applying this definition to the immediate problem, it is apparent that the $500 loss would be allowable *if* the taxpayer could prove that the 100 shares of stock sold were those purchased on October 1, 1960. This identification can be made by certificate number if they were in Mr. Eck's possession, or by specific designation to the custodian pursuant to Reg. 1.1012-1(c). If the identity of the shares sold was established as being those purchased two weeks previously, the sale would not be a wash sale. This is so because Mr. Ecks did not reacquire substantially identical stock within a 30-day period before or after the sale. The second 100 share block of Z Corporation stock that he held on the date of sale had been acquired 10 years previously.

If, however, the 100 shares sold cannot be identified, the first-in, first-out rule comes into operation and the shares sold will be deemed to be those acquired in 1950. The loss on the sale of these particular shares will be disallowed under the wash sale provisions since within 30 days of the sale (actually 14 days prior thereto) Mr. Ecks reacquired the identical stock.

MEDICAL EXPENSES OF DECEDENTS

Medical and dental expenses can, generally, be deducted only in the year in which they are paid. However there is a special relief provision (Section 213(d)) with respect to those medical expenses paid for the medical care of a decedent. These expenditures may, at the election of the executor, be treated as if paid by the decedent at the time they were incurred (which is not necessarily the taxable year of death) if they are paid out of his estate within a year after his death. However, if they are so treated they cannot also be deducted as debts of the decedent in computing his taxable estate for federal estate tax purposes. There appears to be no logical reason for this restriction—if the decedent had paid for these expenses when they were incurred his estate would have been that much smaller.

Before any determination can be made whether to utilize the relief provided under Section 213(d), it is necessary to compare the tax benefits resulting from the deduction of such payments as debts on the estate tax return with the tax savings resulting from their deduction as medical expenses on the decedent's income tax return. It should be remembered that the income tax saving may, in turn, be subject to an estate tax. If the computation indicates that it is desirable to claim the medical expenses for income tax purposes, there must be filed, with or for association with the individual income tax return on which the medical expense is deducted, a statement in duplicate that the amount deducted had not been allowed for estate tax purposes as a deduction, and that the right to have such amount allowed as a deduction for estate tax purposes is forever waived.

What happens if these expenses are not paid until after the decedent's income tax returns have been filed and these amounts have not been claimed as medical expenses? If it is determined that it is advisable to list them as a deduction on the income tax return, an amended return or claim for refund together with the required statement and waiver in duplicate can be filed at any time within the statutory period allowable under Section 6511. But as a matter of course, practitioners should perhaps try to obtain an extension of time for the filing of the final returns of the decedent so that they can thus be certain that all such medical expenses have been paid before the filing of the return.

Classified Section

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Temporary office help available, bookkeepers, clerks, comptometer operators, typists, statistical typists, stenographers, selected personnel. We pay social security, withholding, disability unemployment, compensation payments. O'Neill Office Service, 277 Broadway, RE 2-0288.

CPA, 20 years public accounting and tax experience, modest practice, desires association with firm that can use superior services. Box 2203.

CPA, attorney, very diversified accounting, tax and administrative experience, forty-five, family man. $18,000. In N.Y.C. Box 2204.

CPA, attorney, experienced in taxes, budgets, cost analyses, financial, accounting reporting and interpretation and related functions. National CPA firm experience. Two years administrative controller. Eight years corporate experience. Middle forties. Married. Children. Seeks $15,000. to $20,000. Metropolitan New York corporate work. Box 2205.

Female, bookkeeper, thoroughly experienced, accounting experiences and background, four days per week, $100.00. Box 2206.

CPA, 37, 12 years public and private experience desires position with public accounting firm upstate New York. Box 2207.

Bookkeepers, full charge and assistants, applicants of ability, good appearance and education. Larkin Agency. Estab. 1935. OXford 5-2668.

CPA, write-up specialist with new techniques, seeks work on percent of fee or contract basis. Box 2221.

Comptroller, CPA, age 40. Presently Vice-President and Comptroller of large service organization at $15,000. Top-notch qualifications and experience. Seeks manufacturing corporation opportunity, preferably electronics or chemical. Salary and title of secondary importance to opportunity and quality of corporation. Box 2222.

Accountant, CPA, member of the Society, 10 years diversified experience, seeks per diem position, N. Y., N. J. Box 2223.

CPA, Society member, 10 years experience, seeks per diem work on Long Island 3 days weekly. Box 2227.

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Mail and Telephone Service, at either of these prestige locations, 550 Fifth Avenue or 510 Madison Avenue, including air-conditioned conference and reception rooms for interviews and audits, telephone and lobby directory listings, secretarial facilities. Air-conditioned offices and desk space available. Fifth Avenue Office Service, Inc., 550 Fifth Avenue, New York City 36, PLaza 7-3638.

Practice Wanted, substantial terms, know-how offered overburdened or retiring prac-

BUSINESS OPPORTUNITIES

titioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 2208.

Well Equipped CPA Firm, will purchase all or part of the practice of overburdened or retiring accountants, substantial cash or attractive retirement arrangements will be offered. Box 2209.

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For Rent, air-conditioned attorney's suite, private rooms, recently completed, beautiful decor, facilities, extra space available during tax season, individual or small firm, moderate. WOrth 2-1655.

Practice or individual accounts wanted for purchase by CPA with 20 years experience, no account considered too small. Box 2210.

CPA, over twenty years of diversified public accounting experience, has $8,000 gross and free time, seeks association with overburdened practitioner. Box 2211.

CPA, 35, seeks association with overburdened or retirement conscious practitioner, desires to purchase or manage practice or individual accounts. Box 2212.

Accountants Service Center offers a place to keep things, obtain phone answering service, receive mail, meet a client, do tax research, get reports typed and other chores handled in exchange for an economical sum. Cost can be as low as $5 a month. A whole floor of office and desk spaces at 120 Liberty Street, BArclay 7-5816.

Fireproof insulated legal and letter size filing cabinets, used, refinished like new, 2, 3, 4 drawer. Krasilovsky, 245 Canal St., CAnal 6-2255.

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Expanding New York City certified firm desires to purchase practice in New York City area, including Long Island. Attractive arrangements and substantial consideration. Box 2215.

Office space in air-conditioned fully equipped accountants office with or without services. Merger possibility. Box 2216.

Substantial Cash Available for the purchase of a practice or individual accounts by experienced CPAs. Box 2217.

Madison Avenue 366, room in new suite of attorneys, old established firm, full tax library, complete services. YUkon 6-3060.

CPA, 33, 10 years diversified experience, AICPA, NYSSCPA, seeks partnership with overburdened or retirement conscious practitioner. Box 2218.

CPA, 37, Society award winner with heavy public experience, seeks partnership with overburdened practitioner or one considering retirement, substantial capital available. Box 2219.

CPA wishes to purchase practice or individual accounts in NYC area. My personal service guaranteed for your accounts. Box 2220.

501 Fifth Avenue, (42nd Street), air-conditioned office, 14′ x 13′, in newly decorated corner CPA suite, opposite public library, large reception room, secretarial room, file room, staff room equipped with library and new large formica desks, as well as computing and photo machines. Tenant must have own secretary. Room and use of all facilities $250.00 per month. Lease available to 4/20/65. MU 2-1881.

475 Fifth Avenue, private office available in CPA suite, share secretarial services. LE 2-5237.

CPA with attractive air-conditioned fully carpeted suite, (3 private plus 1 large library reception) including tax library, would rent private office to individual practitioner ultimate partnership possibilities or other advantages could be explored. Room 905, 24 W. 40th St., WI 7-2345.

CPA, 42, medium size practice, seeks partnership with established firm, substantial capital available. Box 2224.

CPA, with quality practice seeks association with equally situated Sabbath Observer CPA with growth and partnership possibilities. Box 2225.

CPA, two man staff, time available on per diem or job basis, will purchase or manage accounts. Box 2226.

Partnership desired by L. I. practitioner, $18,000.00 gross plus extras. Main objectives are mutual security, vacations, sharing of staff and office expenses. Am interested only in practitioners whose gross is roughly equivalent, and from public accounting fees only. Box 2228.

Established two man CPA firm will associate with individual who desires accessibility of mature practitioners. Will share space. Box 2229.

CPA, 34, seeks purchase of accounting practice. Substantial funds are available and attractive terms can be arranged. Box 2230.

THE NEW YORK

Certified Public Accountant

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